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S. HRG. 103–129

TREASURY DEPARTMENT'S BIANNUAL REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

Y 4. B 22/3: S. HRG. 103-129

Treasury Department's Biannual Repo... ING

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

COUNTRIES THAT MANIPULATE THEIR EXCHANGE RATES TO GAIN UNFAIR TRADE ADVANTAGES WITH THE UNITED STATES

MAY 25, 1993

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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TREASURY DEPARTMENT'S BIANNUAL REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

TUESDAY, MAY 25, 1993

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 10:06 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Jim Sasser (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. The committee will come to order.

This morning, we begin again what I hope and expect will be a productive and informative dialog between Congress and the new administration on International Economic Policy.

I want to welcome Dr. Larry Summers before the subcommittee this morning, and shortly, Dr. Summers will present the Treasury Department's biannual report on this critical subject of international economic policy.

But first, I want to take this opportunity to commend you, Dr. Summers, and also Secretary of the Treasury Bentsen, and the President, himself. I want to congratulate all of you for breathing new life into the G–7 coordinating process.

In recent years, as the world economy has slumped, the G–7 has floundered and U.S. influence within G–7 has waned. And pressure and prodding from the United States could easily be deflected in times past with the statement, why don't you do something about your own budget deficit, and then come talk to us.

Well, now we are doing something about the deficit. The President has stepped forward boldly and proposed a comprehensive economic and deficit reduction plan. His plan has been hailed around the world. As a matter of fact, it's gotten more acclaim, I think, internationally than it has internally here in the United States. It has restored credibility with our trading partners abroad.

The New York Times described the initial G–7 meeting, and I quote, as "Mr. Bentsen rides into town tall in the saddle."

So this renewed credibility has created an opportunity to reinvigorate the G–7, and I submit that this opportunity must be seized. It must be seized because global economic growth and trade issues are key to growing the economy here in the United States.

In fact, during the past 3 years, exports have provided all of the economic growth in our economy. In the first quarter of this year, exports declined by a sharp 7 percent rate, and this is a major reason why overall economic growth has been cut at least in half in the first quarter of this year over the fourth quarter of last year, and why, once again, we're seeing very few jobs created.

There's real concern today that the already large trade imbalance will widen, because growth abroad is so slow. There is a critical need for our allies to aggressively stimulate their domestic economies. This is a strange statement to make, I suppose, to some, in view of the fact that we were unable to pass, here in the Congress, a very, very modest stimulus package of our own.

But lower interest rates in Europe and a strong fiscal stimulus program in Japan are needed to put the world economy back on a growth track. Growth abroad is also needed to narrow the large trade imbalance. While growth abroad is absolutely necessary, it is not sufficient in and of itself. U.S. exporters must have fair access to the foreign markets of our trading partners.

Let's take China, for example. The economy in China's booming, but United States exports into China are being held down by Chinese manipulation of the exchange rate and currency reserves. The result is that the United States is running an $18 billion trade deficit with China. So I look forward to exploring this and other key issues with Dr. Summers following the presentation of his report.

But let me again commend you, Dr. Summers, and the entire administration for reinvigorating the G–7 process at this critical juncture.

The chairman of the full committee is with us here this morning, and I'll turn to him for any opening statement he might wish to make.

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. Thank you very much, Chairman Sasser.

Let me say, at the outset, how much I appreciate your leadership as you assume the duties as chairman of the International Finance and Monetary Subcommittee. This is a critical part of the work of this committee and I very much appreciate the fact that you are leading this effort today, just in terms of the whole scope of the work of this subcommittee.

I also want to commend Senator Sarbanes, who was the previous subcommittee chairman, for his important work over a long period of time. And I want to make some opening comments, and then reinforce a point or two that Chairman Sasser has just made.

Under the provisions of the Omnibus Trade Act, which were drafted by this committee, the Secretary of the Treasury is required to submit to us, semiannually, a report on economic policy in the international arena, including exchange rate policy, which brings us here today. We drafted these provisions to ensure that the Executive Branch would make the achievement of a healthy balance of trade a top priority in our international economic negotiations. We also asked the Treasury Department to identify, in each report, those countries that manipulate their exchange rates to gain unfair trade advantages with the United States.

In the past, the Treasury Department has identified both Korea and Taiwan as exchange rate manipulators. Now this morning, for the third time within 12 months, the Treasury will again identify China as manipulating its currency in this area.

Now the facts are these. In 1991, China's trade surplus with the United States was $12.7 billion, and that is in their favor. They drew that much capital out of the United States and the jobs that go with it. But in 1992, that number had jumped substantially and was up to $18.3 billion, a surplus in their favor, a deficit for the United States.

Now the Treasury report submitted to the committee this morning is telling us that China's overall trade surplus with the United States is approaching $20 billion, and may well go beyond that, and that China is continuing to manipulate its currency in order to capture United States markets, and at the same time, restrict the movement of American imports into China. This is totally unacceptable behavior on the part of China, which has now been charged with this improper practice in each of the last three reports by the Treasury Department, and that of course stems now to two administrations.

American workers, for example, who make sporting goods or footwear or clothing are losing their jobs, and they're losing their livelihood, in part, because our Government has continued to let China get away with this unfair practice. Because of this, we're losing opportunities to expand American exports to China, and we are losing jobs in America that would be associated with this fair and expanded export activity.

Later this week, I plan to introduce legislation that would forbid our Government from granting China most-favored nation treatment unless and until it stops manipulating its exchange rate. If China continues its current exchange rate manipulation practices, then under my legislation, they would lose their most-favored nation trade treatment.

Now a second highly disturbing aspect of today's latest Treasury report involves our country's continuing and growing massive trade deficit with Japan. Japan is by far the worst offender in terms of the problems that we have in the trade area. The latest Treasury report suggests that Japan will have an overall global trade surplus this year in excess of $135 billion. And of that, over $50 billion, well over $50 billion will be with the United States. In just the month of March, the United States had a trade deficit with the rest of the world in excess of $10 billion, and of that amount, over half, over $5 billion was with Japan alone. And that means that Japan NET took out of our economy, in a 31-day period, over $5 billion.

That hurts America. It hurts the job base of America. And much of it is due to persistent, long-term, deliberate, unfair trading practices. Barriers to entry into the Japan market that hold out American goods that otherwise should be selling there on a sound, competitive basis, and also a variety of techniques used in this country, including the Keiretsu practices to come in and to sell more in this market than I think can be defended under any definition of international trading rules.

So these sort of trade figures are totally unacceptable and it makes it clear that Japan is continuing to operate its economy, not only to the detriment of the United States economy, but I think clearly to the world trading system.

And so I again today call on the new administration, as I have with past administrations, to use every possible means to force these issues to a showdown with the Japanese to break open their markets so that our goods can be sold there on a fair and equitable basis, and to bring this trade deficit down to a rough balance within a reasonable period of time.

We cannot tolerate a situation where one nation, in this case, Japan, has drawn over $500 billion out of the United States in the trade account since 1980. That's a half a trillion dollars. It's wounded this economy. It's in effect a type of economic warfare, and it has to be confronted and stopped before more damage is done to this country. There is no excuse for it, and the crocodile tears that I see the Japanese leaders shedding mean nothing in terms of the face of the kind of data and job damage and economic hardship being imposed on this country by these practices.

Mr. Chairman, I want to just conclude by saying, with respect to your comments a minute ago, I am very much concerned about the weakness in the American economy, and for that matter, in the global economy. And I hope that our witness today will talk about the economic situation that we're facing at this moment.

We've got consumer confidence data, which has just come out, which is down again. That's a disturbing report, series of reports. There's a lot of softness in the domestic economy, and I think we very much needed the job stimulus program. We still do.

You see Japan having just recently announced a job stimulus program this year of $114 billion, because their unemployment rate is up to 2.25 percent. We were trying to get $16.3 billion and our posted unemployment rate is 7 percent, more than three times as high as what it is in Japan. And ironically, because of this bloated trade surplus that the Japanese have with us, the American people are paying for about half of the stimulus program that the Japanese have just announced. So you've got this terrible contradiction where we're saying, we can't afford to have a stimulus program here in America to get unemployed people back to work, but we're going to allow a trade imbalance with Japan to take over $50 billion out of the country to Japan for which they pay for half of their job stimulus program. That's just wrong, and that can't be tolerated.

But I look forward today to our witness talking about the economic situation, laying the cards on the table face up so that we understand where we are. I'm very much concerned that if this softness continues, and particularly if there's an indifference to the problem in the Congress, and an unwillingness to go with some kind of a stimulus program, that we could find ourselves in a situation where the economy could start sliding backward, and slide into another recession.

I worry very much about that, and I think it's essential that the Federal Reserve not add to a calamity of that kind by raising interest rates. That's out there as another possible element in the mix

that could work very much against the economic recovery that we need in the country at this time.

Thank you, Mr. Chairman.

Senator SASSER. Thank you, Mr. Chairman.

Senator Mack has joined us, and I'll call on him now for any opening statement he might have.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman. I will try to confine my comments, for the next minute or two, to what I expect to hear from Under Secretary Summers, and not respond to the chairman of the full committee and the comments that he has made.

I, too, would like to welcome Under Secretary Summers to the Banking Committee for his first hearing in this new capacity.

International exchange rates are an important factor in the world economy, and I look forward to benefiting from our witness' expertise on this topic. But before we start, I would like to express a concern that I have.

In recent months, both President Clinton and Secretary Bentsen have made statements that have suggested that the dollar is valued too high with respect to the yen. And these statements cause great volatility in exchanges rates, and indicated to international markets that perhaps this administration was going to actively engage in a policy of dollar devaluation.

I'd hate to see this administration promoting a policy of dollar devaluation. I think it is a mistake. It causes an erosion in long-term competitiveness of American industry, and destroys confidence in the value of the U.S. dollar.

I know that Under Secretary Summers considers that manipulation of exchange rates to be inappropriate, and has said so publicly. I agree with him, as he was quoted in press reports in April, stating that, "excessive volatility is counterproductive for growth." So I'll be interested in hearing your views this morning.

Thank you, Mr. Chairman.

Senator SASSER. Thank you, Senator Mack.

Mr. Secretary, we turn to you now, and listen with great interest to your statements and observations.

STATEMENT OF LAWRENCE H. SUMMERS, UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. SUMMERS. Thank you very much, Mr. Chairman.

I'm delighted to be here with this committee to discuss these very important issues. I'll submit a prepared statement that goes into more detail than what I'm going to say right now.

In a sense, the title of the report that we're submitting to you is a bit of an anachronism. It's a bit of an anachronism because international economic policy can no longer be delinked from domestic economic policy.

Our prosperity at home depends upon our success abroad. It depends on our success abroad particularly because of the critical role of exports in promoting the health of the American economy.

The President has put forth a bold program of domestic revitalization that emphasizes increases in public investment, and also emphasizes the critical role of budget deficit reduction in the long

run. That emphasis on budget deficit reduction corresponds to what our allies have asked us to do for many years. It also provides us with a key vehicle for addressing the problem of the twin deficits that plagued us throughout the 1980's, a budget deficit and an associated trade deficit.

But if reductions in budget deficits are to succeed, we must see interest rates decline, and we have seen interest rates decline. But we must also see the trade deficit decline from where it would have been because of the budget deficit reduction. One way that can happen is the way we don't want it to happen, through a reduced U.S. economy that's less strong and able to import less.

The way we want to see budget deficit reduction translate into a reduced trade deficit is through increased U.S. exports. That's why an export activist trade policy, directed at opening foreign markets, is so important, and that's why macroeconomic cooperation directed at spurring global growth is so important, as well.

I want to concentrate briefly, this morning, on the macroeconomic element of a strategy. It's a critical time. The U.S. economy, as Senator Riegle said, is recovering, but the recovery is slower than we would like it to be, and certainly does not have the kind of job creation impact that we would like it to have.

The economies of Europe and Japan are not as far along in the cycle as we are, and so recovery is less clearly underway, and indeed in Europe, there is substantial evidence of continuing economic decline. This is a problem for the citizens of the industrialized world where unemployment in the industrialized world is steadily increasing. It is also a problem for us because slow growth abroad means slow growth in the demand for U.S. exports, and it also means more protectionist pressure and more resistance to entry by U.S. firms into foreign markets.

That's why, as Senator Sasser said, President Clinton and Secretary Bentsen have made revitalization of the G–7 process such a key priority. And I think we've been very successful so far. In the first 100 days of the administration, there were three G–7 Finance Ministers meetings. There was meaningful dialog at those meetings.

Secretary Bentsen's taking a somewhat different approach to the process than has been taken before; much more emphasis on quiet cooperation directed at real results and much less emphasis on public hectoring.

We've seen the first fruits of that policy. Japan has taken a first step toward stimulating its economy, toward increasing domestic demand, using fiscal policy, in order to encourage its economy to grow more rapidly, and be in a position to accept more imports.

In Europe, we have seen German interest rates decline, as conditions for relatively stable inflation have been laid through reduced budget deficits and through some favorable wage settlements.

We've seen French interest rates decline quite substantially following the French election to the point where the spread between French and German interest rates has largely disappeared. But the world growth problem remains. Even with all of these measures, international organizations are forecasting relatively slow growth. And so, as we move toward the summit and beyond, we're going to need more to spur growth in the industrialized world.

Let me also comment, briefly, on what has been an important subject in these reports in the past; the question of specific countries that may be manipulating their exchange rates.

In our continuing review of newly industrialized economies in Asia and China, the Treasury has concluded that China continues to manipulate its foreign exchange system in a manner that prevents effective balance of payments adjustment. China has continued to sustain global trade and current account surpluses, and its bilateral trade surplus with the United States grew to $18 billion on 1992.

These outcomes, as well as the pervasive and inflexible restrictions on access to foreign exchange in China—and I would stress the importance of those restrictions in our thinking—measures which deny potential importers of American goods in China the opportunity to get access to foreign exchange to import those goods, underlie our conclusion. I have stressed, in my talks with Chinese officials, that the recent narrowing of China's global surplus reflects the overheating of the economy and that this surplus, because it reflects the overheating of the economy, will probably be reversed as growth drops to a more sustainable pace. Therefore, it cannot be interpreted as indicating that there is no further need for liberalization of the foreign exchange regime.

You will note that we no longer find that Taiwan is a manipulator. While Taiwan does still have global trade and current account surpluses, these surpluses have declined. Also, Taiwan does not appear to be intervening in exchange markets to manipulate the value of its currency or to limit appreciation. Nevertheless, since the tools that could bring that about remain, i.e., continue to be in the hands of the Taiwanese authorities, we will monitor the situation in Taiwan very closely.

That concludes my remarks. I'd be happy to answer questions.

Senator SASSER. Well, thank you very much, Mr. Secretary.

A little over a month ago, the Japanese Government announced a fiscal stimulus package that received substantial acclaim around the world. And I must say, however, that I was surprised to see that even with the announcement of that stimulus package, the International Monetary Fund [IMF] still predicts only 1.3 percent real growth in Japan this year. Am I correct in my reading of this report? Does the IMF 1.3 percent growth figure include the stimulus package?

Mr. SUMMERS. I believe it does.

Senator SASSER. That was the stimulus package has been variously reported about $116 billion to $119 billion which would work out, if that is really an accurate, if that is really a stimulus package, would work out to what? About 2 to 3 percent of the Japanese GDP?

Mr. SUMMERS. Senator Sasser, there are I think several points one has to take account of in evaluating that stimulus package.

Senator SASSER. That's what I was going to come to, but go ahead.

Mr. SUMMERS. First, a substantial part of that stimulus package doesn't really represent incremental government spending. It simply represents the government is making available loans to people to make investments who otherwise would have been in a position

to borrow to make those investments in the private market. And so this so-called FILP spending is not regarded by most economists as providing additional stimulus.

Second, the stimulus package can't be evaluated without looking at what the benchmark is. And had there been no supplemental stimulus package, Japanese fiscal policy would have been quite contractionary this year, and so a significant part of the stimulus really served to bring the budget up to the neutral level.

Once you take account of those two factors and some other technical issues, I think you come to the conclusion that the Japanese fiscal package is a useful and valuable contribution toward global growth, but it is one that leaves room for further efforts in the future to spur domestic demand in Japan.

And that really is, I think, the critical priority. In the past, in Japan, there have been periods of export-led growth, where the demand from foreign sources has pulled the domestic economy along, in a sense where domestic demand growth was less than domestic supply growth. Now we need something. Now we're looking for something quite different—a period of domestic demand-led growth where a growth of domestic demand actually exceeds the growth of production, so that you see the trade surplus come down.

Senator SASSER. Well according to the Nikkei Weekly, part of this so-called stimulus package was to be paid for with higher taxes. Moreover, this particular article that I allude to said that much of the spending program was not, to use their term, "real water." That it included things like purchases of public lands that have little or no stimulative effect. And you've indicated that the actual stimulus was overstated considerably.

What is the bottom line size of the package? And by that, I mean the year over year change in the structural deficit or surplus?

Mr. SUMMERS. There are a variety of different estimates, but I think a fair characterization would be that there has been a modest reduction in the Japanese structural surplus, that is far less than 1 percent of GNP, and that, with the package in place, the Japanese budget in aggregate continues to be in surplus.

Senator SASSER. Isn't it sort of a rule of thumb among economists that if you're going to get any genuine meaningful stimulus, you have to come with about 1 percent of GDP in stimulus?

Mr. SUMMERS. That would be a commonly accepted economic proposition in discussions of many industrialized economies, yes.

Senator SASSER. Right. Do you agree with that, Mr. Secretary? I'm not trying to put you on the spot. I want to get your opinion about it.

Mr. SUMMERS. I would have liked to see larger Japanese actions to provide fiscal stimulus to their economy, but, as I said, I think what we've seen is a useful step. We will in the G–7 process, be discussing the importance of domestic demand-led growth, which is best produced in Japan by fiscal policy, and is critical to a successful Japanese recovery, and to a successful world economic recovery.

Senator SASSER. Let me ask you a fundamental and basic question. In view of the fact that we're running a trade deficit with the Japanese of about $50 billion a year, how does it benefit our economy for the Japanese economy to be growing?

Mr. SUMMERS. The more rapidly their economy grows, the larger their market is, and the more imports of American goods that they take. That's why I keep emphasizing domestic demand-led growth. Crudely put, if you put more money in the hands of Japanese consumers, they will buy more American goods.

If the government makes more purchases, particularly if it makes the purchases appropriately, some of those purchases will fall on American goods, and some of those purchases will fall on Japanese goods, which will put money in Japanese workers' hands, which will lead to increased purchases of American goods.

So it's growth, but I emphasize that it's domestic demand growth. Domestic demand has to be the driving force in the growth, not increased foreign sales, because of the large Japanese imbalance.

Senator SASSER. Well, let's turn, for just a moment, to what's happening in Europe. Now German short-term interest rates are at about 8 percent. And we know that because of the exchange rate mechanism, other European countries are effectively forced to keep their interest rates up also. In other words, the deutschemark leads the other currencies in Europe.

Now, with rates as high as 8 percent, you would expect there to be substantial inflation in the German economy. But if you look at the IMF figures, they report inflation in France is running at 2 percent. Inflation in Germany is running at about 3.4 percent after you take out the one time 1 percent VAT tax increase.

Now next year, the IMF expects inflation in France and Germany to be at about 2.5 percent, that's in 1994. Now if you subtract that 2.5 percent inflation from the interest rate, you come up with a real interest rate of in excess of 5 percent. Now that is a very, very substantial real interest rate.

Dr. Summers, does this not suggest that there is considerable room yet for European interest rates to come down, and specifically German interest rates?

Mr. SUMMERS. Mr. Chairman, for reasons that I think are clear enough, administration officials traditionally are very reluctant to make direct prescriptions as to what our own central bank should do, let alone to the actions of the central banks of other countries.

I would say, however, two things.

First, a substantial part of the German situation is a consequence of a very skewed fiscal/monetary mix, in many ways similar to the one we had in the United States in the early 1980's.

The German equivalent of the defense build-up and the Kemp-Roth tax cut is the actions that are being taken to spur East German reconstruction—in the context of German unification.

Those high real interest rates are a consequence of very expansionary fiscal policy, mirrored by tight monetary policy to keep inflation under control. The real interest rates are extremely high, and they are having substantial consequences in the rest of Europe, but I think it's important to understand that their fundamental source lies in the very dramatic change in the fiscal/monetary mix that we've seen in Germany.

I think that we're seeing some of the preconditions for lower interest rates, and indeed the pace of interest rate reduction in Germany has increased in the last several months. And I would cite

increasingly favorable inflation figures, increasingly favorable wage settlement figures, some improvement of figures in terms of money growth, and the Solidarity Pact that will help control budget deficits. These are factors working in the direction of making it easier for interest rates to come down over time.

But there's no question that the situation is a very difficult one, and wherever you have real interest rates in the 5 to 6 percent range, you are going to have very real strains.

Senator SASSER. Well, of course we're all aware that the Germans have an historic fear of inflation that goes back to their experience after the First World War, but I don't think it's exaggeration to say that the rest of Europe and the United States, to some extent, are helping, are suffering economically from the German effort to finance the German unification.

In other words, that's the reason for an expansive fiscal policy which the reaction is a very restrictive monetary policy. So I think you could make the case that, to some extent, the rest of Europe and the United States are helping shoulder the burden of German reunification. It seems as if we never get World War II behind us.

Let me turn to Senator Mack for any questions he might have.

Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I'd like to pick up on where I left off with my opening statement. In essence, you have said that you believe that manipulation of exchange rates is inappropriate, and again, I support you. But I wonder, though, what you would say in response to headlines like the one that was in a Wall Street Journal op ed piece, "Yen Appreciation Does Reduce Japan's Surplus." Since you have been so forcefully against exchange rate manipulation, how would you respond to those in favor of manipulating currencies to address our trade deficit with Japan?

Mr. SUMMERS. Let me first just clarify that administration exchange rate policy continues to be along the lines of the statement that Secretary Bentsen made at the end of April, that was embodied in the communique of the G–7 Ministers.

It recognizes that exchange rates need to reflect economic fundamentals. It rejects artificial influence on or manipulation of exchange rates. It recognizes that excess volatility can be counterproductive, and indicates that we stand ready to cooperate with our partners in foreign exchange markets. So that——

Senator MACK. That's a statement that basically says we really didn't mean the things that we said earlier. It was not to be a policy statement, but the idea that the dollar is valued too high with respect to the yen is not statements we would expect to hear then in the future?

Mr. SUMMERS. We reject, as I said, manipulation of exchange rates, and it is our firm conviction that there is no way to devalue yourself into prosperity. And that that is not a viable strategy for producing prosperity.

At the same time, I would emphasize that exchange rates do, as we say, reflect fundamentals, and that fundamentals are influenced by changing cyclical conditions and by changing monetary and fiscal policies in different countries. And while I have very firmly rejected manipulation of exchange rates as a strategy for trying to do

something about trade balances or anything else, I think it is important to recognize as an analytic proposition that, when exchange rates move, they do have an impact on competitiveness. And that there is that impact which does, over time, show up in trade flows. But that in no way justifies or constitutes any argument for a policy of trying to devalue your way into prosperity.

Senator MACK. OK, I appreciate that comment. I'd like to shift to Russia for a moment, and the pursuit of an idea that I have raised on several occasions, and has been discussed for quite some time, and that's the concept of using a currency board or something similar to a currency board to try to get a hold of the inflation rate.

I guess the whole thing I'm driving at is we're going to provide some $28 billion in assistance to Russia despite a 300 percent rate of inflation there. Basically, what we will be giving them will be gone within a very short period of time.

There is a better way. Both Argentina and Estonia have recently linked their currency to a hard currency using elements of the currency board concept. Both saw inflation drop significantly, in fact, almost immediately.

The Estonian experience was so successful that Jeffrey Sachs and the IMF were both claiming credit for it in a World Bank newsletter, though I believe the Estonians really pursued it on their own.

Now, I know that the Russian Government and the Central Bank have reached a new agreement to control inflation, but knowledgeable Russians are already saying that the new agreement is almost certain to be violated.

I believe a currency board would be a great solution, perhaps the only solution that has a chance. Have you been looking into stabilizing the Russian currency through a currency board? And have you had discussions with the Russians with respect to this?

Mr. SUMMERS. Senator Mack, I think there's a great deal of power in the concept. The Estonian experience, and to a lesser extent, because the economies are different, the Argentinean experience, are examples for other countries is a good example—for other countries, to a somewhat lesser extent, because the economies are more different, such as the Argentinean experience.

But I think if you look carefully at those experiences, what you see is that the fixed exchange rate currency board concept was very powerful in providing credibility and in facilitating stabilization. But the success of the stabilization program was ultimately anchored and dependent, not on the establishment of a currency board, but on the government's taking the difficult measures to reduce the budget deficit and to control the growth of credit to enterprises.

If you don't control the growth of credit to enterprises, no matter what your exchange rate mechanism is, you're not going to viably stop inflation. So I think the first priorities in Russia have to involve staunching these rather enormous credit flows, controlling the budget deficit by reducing subsidies and the like, and charging firms something that approaches a market interest rate.

As long as you're printing money at a fierce clip, and as long as there are political pressures that can't be resisted to provide this

credit, no exchange rate system is really going to viably protect against inflation.

I think that after you have some clear commitments to implement these fundamental policies, then systems that rely on pegging the exchange rate in one way or another, perhaps a currency board concept, can make a very valuable contribution to stability.

Senator MACK. The concept has been used in Russia twice before. It's in use today in Hong Kong. And I don't know that I know enough to be able to get into a discussion with you about the other factors necessary and the total experience with respect to Argentina and Estonia.

But it seems to me, again, when we're asking the American people to participate in assistance to the country, that we would want the kinds of assurances that you had mentioned in your statement. Certainly I hope we wouldn't be prepared to go ahead with that $28 billion without those kind of assurances.

And I guess the last point that I would make is that I'm not talking about imposing a currency board as the only mechanism. I would suggest that the currency board could issue a parallel currency, if you will. A hard ruble issued by a currency board would drive out the soft rubles issued by the central bank, on the theory that good money drives out bad. It is clear to me that if you have a currency board, you're going to see the Russian people wanting this currency that has real value to it.

I'm not trying to get a commitment out of you that this is the way to go. What I really would like to hear from you, though, is whether there is a willingness on your part and the Treasury's to get into some discussions about this concept of a currency board with the Russians. Because I have heard that there are a number of Russians who are interested in this idea, and I think we ought to be pursuing it.

Mr. SUMMERS. Let me start by saying, Senator, that the Treasury absolutely believes that the control of inflation is absolutely critical to the Russian reform effort. History teaches us that there's never been a stable democracy with hyper-inflation. Getting control of the inflationary process is absolutely central to the reform effort in general, and to ensuring that any other assistance money is used wisely—that, for example, farmers plant seeds, rather than plant deposits in Swiss bank accounts, requires getting control of the inflation process.

There is no question that institutional monetary arrangements like currency boards can make an enormous contribution to the control of inflation. And we hope and expect that it will be a subject that will come up in our discussions and the IMF's discussions with Russia on monetary arrangements.

I would stress the near term preconditions for that to work. A budget deficit that is under control and reduced credit growth have to be our top priorities.

And, finally, I would express some reservation about parallel currency systems, which I do think have a great deal of potential to produce instability, as people rush into one currency and out of the other, and the other currency hyper-inflates. I would rather see a more pure system than a parallel currency system.

Senator MACK. I would make the point, Dr. Summers, that frankly there is already a dual system under way in Russia today, anyway. As a matter of fact, most economists indicate that the dollar is more important than the ruble. At least, there is movement away from the ruble to the dollar. So I think there is value to the concept of parallel currency. But we can discuss that later at some other time.

Mr. Chairman, I wonder if I might be able to—be permitted to ask one additional question, because I am probably going to have to leave.

Senator SASSER. All right.

Senator MACK. It has to do with China and the comments you made with respect to China and the manipulation of their exchange rate system, I think is the way you referred to it. And this is now just kind of one additional argument, if you will, for those of us who have been making the case that there should not be an extension of most favored nation status to China.

How does the administration, given all the other debate that has been going on about proliferation of weapons systems, human rights concerns, and now this issue of manipulation of exchange rates—how is it possible that China is ever going to take us seriously?

President Clinton campaigned against the butchers of Beijing and said he would not extend most favored nation status. And now here you are this morning testifying that, in addition to all the things that we have talked about for the last year or so, there is an additional thing, and that is manipulation of the exchange rate system. And how can the administration defend a position of extending most favored nation status?

Mr. SUMMERS. I am not in a position to get ahead of the administration in terms of describing its policy with respect to MFN extension for China. I don't think there is any question that there are a variety of very real and important issues with respect to China that concern American economic interests, American values, and American security. But I am not in a position to get ahead of the President in terms of describing or defending the administration's policy with respect to future policy with respect to the MFN exemption.

Senator MACK. Let me make the point more focused, without putting you in a position of having to stake out what the administration's position might be. But my point is that if we do extend it, then how are you going to convince the Chinese that they need to do something about their exchange rate when they are not prepared to move on something that he campaigned on, that the Congress has been adamantly trying to make a statement about the need to cut off most favored nation status? How in the world can you ever—what is your leverage then? How are you going to convince them that you really mean it?

Mr. SUMMERS. I think on the narrow question of the exchange rate, which really is a much narrower question than the broader set of issues in the Chinese relationship, that there has been some progress in the form of liberalization of the exchange rate system, that we sense the likelihood that there will be further progress.

After all, the exchange rate is now at a level where the black market exchange rate is 50 percent lower than the existing exchange rate. That tells you, I think, something. The fact that the global surplus has declined considerably tells you something as well. And we made very clear that, in the context of China's desire to join the GATT, the exchange rate issue will be one that figures centrally.

Senator MACK. And my last comment is that what I am saying to you is I think you are going to find it extremely difficult for the Chinese to take you seriously with what you are trying to accomplish with respect to exchange rates when we failed to move on most favored nation status.

Senator SASSER. Thank you, Senator Mack.

We are pleased to have the former chairman of the subcommittee, Senator Sarbanes, today to return to his old haunts here.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I would like to make a brief opening statement before I put some questions to Secretary Summers.

Senator SASSER. Absolutely.

Senator SARBANES. We are very pleased to have the Under Secretary here this morning to testify on the Treasury Department's report to the Congress on international economic and exchange rate policy. The 1988 Omnibus Trade and Competitiveness Act required this report from the Treasury to Congress each year on economic policy, including exchange rate policy, with a written update every 6 months after the initial report.

The report this morning is the out date of the fifth annual report which was submitted toward the end of last year. The impetus for this reporting requirement which we have now been pursuing since the 1988 Act was experienced in the early 1980's when a rapid appreciation of the dollar took place with no action by the administration then in power to respond to the increase. The result was a devastating deterioration in the U.S. balance of trade that we are still coping with today.

In fact, I spoke to Europeans at that time who could not understand why the United States was refusing to address that overvalued dollar. And it was not until Baker went to the Treasury in the Plaza Accords that an effort was made to deal with it. Meanwhile, we were running these huge trade deficits. Our international asset position deteriorated, and in fact so much that we went from being a creditor to being a debtor country.

Last week, the Commerce Department released the U.S. merchandise trade figures for March. The report showed that the U.S. trade deficit increased by $10 million in March alone and by over $25 billion during the first 3 months of this year.

There has been a very disturbing deterioration in our trade balance. Last year, it deteriorated to $84 billion, an increase of almost $18 billion from the $66 billion trade deficit in 1991. And this year it looks like it is going to go over $100 billion.

The major challenge for the new administration will be to come to grips with the stagnation in the world economy to find a means

to stimulate world economic growth. And therefore, we of course are interested in the G–7 plans.

Secretary Bentsen in February made a concerted effort in that regard and we have seen some positive action from both the Germans and the Japanese. And I am very concerned about or interested in what the administration's plans are for the July economic summit in this regard.

Now the 1988 Trade bill also requires the Treasury Secretary to analyze exchange rate policies of foreign governments and to consider whether they are manipulating the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments, adjustments, or gaining unfair competitive advantage in international trade.

I think members of this committee regard this as a very important provision that was designed as a mechanism to help prevent a recurrence of the developments about which I spoke earlier by improving the dialog between the executive branch and the Congress. That report has been taken seriously by this committee. In fact, we have held a hearing on the report or its update each and every year.

As Chairman Sasser indicated, I was privileged to chair some of those hearings and I am delighted that his first hearing as chairman of this subcommittee is on this very important issue here this morning. It seems to me there is reason to be concerned about the international economic outlook.

The interim committee of the board of governors of the IMF at its April 30 meeting said:

> With economic stagnation or decline in most of Europe, only tentative indications of an upturn in Japan, and quite gradual recovery in the United States, 1993 will be the third straight year of generally poor growth for industrial countries.

Now if the Treasury finds that manipulation is occurring with respect to countries that have material global current account surpluses, have significant bilateral trade surpluses with the United States, Treasury is required to initiate negotiations with such foreign countries to ensure that they regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage.

Now in the report submitted last year, Treasury found both China and Taiwan were manipulating the exchange rate of their currencies within the terms of the statute. In the update submitted this morning, Treasury has determined that China is continuing to manipulate its currency within the terms of the statute to gain unfair competitive advantage in international trade. And it is to China that I first want to direct my attention.

The United States bilateral trade deficit with China in 1992 was $18.2 billion, second in size only to our trade deficit with Japan. During the first 3 months of this year, the U.S. balance of trade with China has continued to deteriorate. And therefore, I think that raises a very serious problem in trade relations, and indeed not only in trade relationships, in the basic relationship between our two countries. Of course, you were in China only recently; is that correct?

Mr. SUMMERS. I was in China, not as a United States Treasury official, but as a World Bank official late last summer.

Senator SARBANES. Who went to China recently from the administration to raise our concern over a number of these issues that are on the agenda?

Mr. SUMMERS. I believe that was Winston Lord, who is the Assistant Secretary of State for that area.

Senator SARBANES. Well, is the Treasury in negotiation with the Chinese over this currency manipulation issue?

Mr. SUMMERS. We are engaged in discussions with the Chinese Central Bank and Minister of Finance, yes.

Senator SARBANES. Mr. Secretary, am I correct, I believe that China's economy is growing? In fact, you say it right in your statement. The Chinese economy has grown enormously in recent years and continues to exhibit tremendous potential growth. Last year exceeded 12 percent. Is that real growth?

Mr. SUMMERS. Yes, it is.

Senator SARBANES. Real growth of 12 percent. In the first quarter of this year it will reach 14 percent on an annual basis. What is the real growth rate in the United States?

Mr. SUMMERS. It was 1.8 percent in the first quarter, Senator, based on very preliminary estimates. And we are expecting somewhere in the 3 percent range over the course of this year.

Senator SARBANES. 1.8 percent in the first quarter and you're hoping for 3 percent for the year. And the Chinese are going to be at 14 percent this year?

Mr. SUMMERS. Well, they are certainly growing much more rapidly than we are. Fourteen percent in the first quarter is not sustainable over the course of the rest of the year.

Senator SARBANES. Now, of course, if they are building up a trade surplus, exporting more than they are importing, that contributes to the growth of their economy, does it not, in a very significant and substantial way?

Mr. SUMMERS. It certainly does.

Senator SARBANES. And they are achieving that trade performance in part, at least, perhaps in very substantial part, by manipulating their currency?

Mr. SUMMERS. Senator, we have labeled them a manipulator because we see critical problems with their exchange rate system. But I would note that the Chinese global surplus is not likely to be very large this year.

Senator SARBANES. Why do you think that is? What do you think is happening that leads the Chinese—this is an interesting point and I would like to explore it with you for a moment. What is it that—why is it that they are running these very large trade surpluses with the United States but not elsewhere, if that is correct? Is there an accounting difficulty or other countries in their trade relations with China sort of—are they demanding greater reciprocity, more quid pro quo in the trading arrangements and not allowing this escalation of a very large trade deficit which we have permitted to happen? Now I am not really hanging this on you. When were you sworn into office?

Mr. SUMMERS. April 5.

Senator SARBANES. Well, you haven't been there long enough yet to really alter the situation. You have inherited a situation. But what is happening?

Mr. SUMMERS. I think there are a couple of different things to say. One is, as the Chinese economy is growing so rapidly, its demand for imports, both of consumer goods and capital goods, is increasing very rapidly. And that is causing, all the time, its surplus to come down.

Senator SARBANES. That is not growing with us, though, is it? Let me show you this chart.

[Laughter.]

Senator SARBANES. I mean, it is an interesting point. In fact, you're saying their economy is growing 12 percent real growth last year, 14 percent this year. Therefore, they are pulling in imports from elsewhere. And yet, our trade imbalance is going up in a very significant way. What I am getting at is I am beginning now to suspect that other countries in their trading arrangements with China are insisting that there be some reciprocity, that it be a two-way street. And the U.S. relationship is essentially a one-way street.

Now this line here, that is our exports to China. They have risen somewhat. But I don't think anyone would regard this as significant. This is 1981 and we were here, and this is 1993 and we are there.

[Indicating.]

Senator SARBANES. A little higher; not much.

What has happened is that the imports from China into the United States have just escalated, particularly beginning in about 1986, 1987, at a phenomenal rate. And this is this climbing line here. And, of course, this gap is reflected in the deterioration and in the trade balance.

Now, every time we start talking about this China trade relationship, we get these people, some of our colleagues even, running on the floor and they talk about our exports to China. Well, there are some exports, but they are not growing. What is really growing are our imports from China.

Now the imports from China mean jobs in China, not here. And in fact, I think the United States trade deficit accounts for almost all of the Chinese positive trade balance worldwide; is that correct? Actually it may account for more. What is the Chinese trade balance worldwide?

Mr. SUMMERS. Senator, I am not trying to be evasive.

Senator SARBANES. I hope not.

Mr. SUMMERS. The difficulty is that the data used in calculating the U.S. surplus that you have reflected in your chart here are based on one set of concepts, used by the Department of Commerce.

The data used in calculating the Chinese global surplus are based on another set of concepts. The difference arises when goods are exported from one country to a third country and then re-exported, which is a very large issue with respect to China, given the importance of Hong Kong and its trade. And so for that reason, we do not have a set of data on a comparable basis that include the Chinese bilateral relationship with the United States and the Chinese global relationship. And that makes it difficult to give a meaningful answer to your question. What I think we can——

Senator SARBANES. Is it not possible to provide data using the same concepts?

Mr. SUMMERS. I will make available to you the best possible analysis. But essentially——

Senator SARBANES. Having done that best possible analysis, and using comparable concepts, what do you find the Chinese world trade balance to be and what do you find the United States trade balance to be?

Mr. SUMMERS. The Chinese world trade balance is substantially lower than the Chinese-United States trade balance.

Senator SARBANES. So in other words, the United States is more than providing all of China's world trade positive balance; is that correct?

Mr. SUMMERS. In an arithmetic sense, it is. In a different sense, however, China is running a significant deficit vis a vis Hong Kong. And that is a consequence of goods that China is exporting to Hong Kong, which are then exported to the United States.

Senator SARBANES. Where are those goods produced? In China?

Mr. SUMMERS. In China, yes.

Senator SARBANES. So those goods mean jobs in China?

Mr. SUMMERS. Yes.

Senator SARBANES. So it is reasonable, isn't it, that those goods would be included in the Chinese figures and not in the Hong Kong figures? I mean, I understand. What the Chinese as I understand it seek to do is they say, well, we're not running this large trade deficit with you because you are running the trade deficit with Hong Kong, because they are sending the goods to Hong Kong and Hong Kong sends them to the United States. Hong Kong is their passthrough, their port of departure. But the goods are being produced in the PRC, are they not? And when we make a calculation, we attribute them to the PRC, don't we, when we do our own bilateral calculation?

Mr. SUMMERS. I can promise you that the note we will send you will be accurate. I cannot promise you that what I am saying now is precisely accurate. But I think the issue also involves the exports that go from the United States through Hong Kong to China, which show up as United States exports to Hong Kong, even though they are ultimately intended for Chinese destination.

The key point is that China runs a deficit globally with Hong Kong. That means that they are importing more from Hong Kong than they are exporting to Hong Kong. And some of those imports from Hong Kong have United States production behind them. And that is one of the reasons why the exports figure on your graph does not show so much growth.

Senator SARBANES. Now that is an interesting point. We really need—because I am now looking at actually the chart in your report just submitted to us this morning, on the last page. And it shows that the trade imbalance between the United States and Hong Kong in 1992 was minus $700 million; is that correct?

Mr. SUMMERS. Yes, that is correct.

Senator SARBANES. Well, that is not even an offset. It is just—it compounds the deficit problem; isn't that right? In other words as I understood your answer just now, you were suggesting that there was significant United States exports going to Hong Kong

which then passed through to China which are not counted in the China trade balance. And therefore, we should, if we really equalized these concepts, we ought to take that into account.

Namely, if we are counting goods coming out of China and passing through Hong Kong to the United States to the PRC and the trade relationship, that we should count goods going into Hong Kong and on to the PRC and the trade relationship.

Now I don't know whether they are being counted or not, but in any event, even if they are not, the order of magnitude is not very great. And in any event, it is negative. So it only worsens this picture that I have presented this morning, wouldn't that be correct?

Mr. SUMMERS. It is certainly correct that if you take the United States deficit with the whole Chinese area that includes Hong Kong and Taiwan, that that is greater than the United States deficit with just the PRC.

Senator SARBANES. You treat Taiwan differently?

Mr. SUMMERS. Hong Kong. It is certainly true if you take—it looks like it is true that if you take the United States deficit with China plus Hong Kong, it is bigger than the United States deficit with China.

Senator SARBANES. Right.

Mr. SUMMERS. But I think that, if you want to understand the global Chinese figures, which is what I was referring to, and why the global Chinese figure is low, even though the surplus with the United States is high, that you cannot just attribute it to other countries' demanding more effective reciprocity. But you have to recognize that some of that is due to the Chinese deficit with Hong Kong. And the Chinese deficit with Hong Kong has to do with something other than the demanding of reciprocity.

Just how important these adjustments for flow through with Hong Kong are with respect to the United States versus how important they are with respect to Japan, Europe, China's other trading partners, is something we will have to do some analysis of and get back to you on.

Senator SARBANES. Mr. Secretary, let me make this final observation. I am told that a number of the European countries press a very hard reciprocity position with the PRC. And that, in effect, they say, look, we are not going to let your exports to us escalate unless we get a comparable access into your market. And the consequence, since we apparently are not doing that, is that the Europeans are getting part of that market that otherwise might come to the United States. Because the Chinese, if they are manipulating the trade with us, they are in a position to manipulate it with the Europeans. And if the Europeans are driving, as it were, a harder bargain or insisting on reciprocity and are getting it, then we are the ones that are being disadvantaged.

We get all these people in this country who talk about the great China market when the exports have not significantly gone up and the imports are going up at an astronomical rate.

Mr. Chairman, the red light is on. I will stop here. I would like to come back with another round.

Senator SASSER. Sure.

Mr. SUMMERS. Let me promise that we will get back to you, Senator Sarbanes, on the analysis of the composition of China's global

trade position vis a vis different regions of the world and how it is influenced by the policies of those different regions of the world as well as by these data issues that I mentioned.

Senator SASSER. Thank you, Senator Sarbanes.

Mr. Secretary, following up on Senator Sarbanes's line of questioning here, using your chart, if we look at the trade deficit that the United States is running with China, it is steadily going up from 1985, where there was a trade balance, jumping steadily to now we have an $18.3 billion trade deficit. And it just comes up incrementally year by year.

Now the question comes, what concrete steps is the administration prepared to take to reduce China's trade surplus? Is the administration prepared to use section 301 authority to sanction the Chinese?

Mr. SUMMERS. I am reluctant to get ahead of the President and Ambassador Kantor on the question of specific trade measures. I can say that I am very confident that the administration will vigorously pursue the opening of the Chinese market.

Senator SASSER. I am pleased to hear that. And I think what you can take away from this hearing here today and impart to your colleagues in the administration, there is great concern here at least with regard to members of the subcommittee, and I think a broad concern across the Senate, that we are greatly concerned about this growing trade imbalance between the United States and the PRC, particularly in light of the evidence, and I think uncontroverted evidence, that the PRC has been manipulating their currency.

Now, following up on that question, many of our exporters complain about the predatory trading practices of the Europeans and the Japanese. And clearly, currency manipulation by the Chinese would fall within this category as well.

Now, some years ago, we created here a so-called War Chest within the Export Import Bank in order to give the executive branch some flexibility in responding to the predatory practices of so many other countries. Now the question is, could EXIM's War Chest or some other program provide an effective response to the kinds of currency manipulation now being undertaken by the Chinese?

Mr. SUMMERS. Let me get back to you on that. My understanding was that it was usually to be used in situations where other countries were being predatory in their export financing practices when selling in third markets. And I am not sure that, given the basic problem of the Chinese market being too closed because people cannot get access to foreign exchange, how much we can do with the War Chest. But let me look into that and get back to you.

Senator SASSER. All right. Let's get on a more positive line here.

I pointed out in my opening statement that the President has tremendously enhanced the credibility of our country and his administration in its role within the G–7. President Clinton has done this by boldly stepping forward with an aggressive and courageous deficit reduction plan. The attention span of many people in this country is so short that they have forgotten that. And we see now many of the same deficit hawks who for years have been complaining that we need to reduce the deficit are now running around like

Chicken Little saying "the sky is falling," and saying, "yes, we want to reduce the deficit but not this way."

They cannot seem to come to grips with the fact that reducing the deficit is going to require some sacrifice, minimal sacrifice, I might say, in most areas. And it might even involve some political risk, minimal political risk, I might say, on the part of some political leaders.

But in any case, I want to ask you this question, Mr. Secretary. Is it not critical that this Congress pass the President's plan, that is, his deficit reduction plan, in order to bolster the renewed credibility that we are experiencing among our G–7 partners?

Mr. SUMMERS. It is absolutely critical to U.S. capacity to provide leadership in the G–7 that we carry through with the commitments that the President has made to revitalize our economy. The critical step in doing that is legislating the President's program of deficit reduction.

The bond market response to that program since the election is indicative of its importance and its credibility. I think it is critical to our providing leadership that it be legislated as soon as possible.

Senator SASSER. Let me ask you this question. If we do move forward and put in place the President's deficit reduction plan, would we not then be in a much better position to go to our G–7 partners and say to the Japanese, for example, look, you have got a situation here where your debt as a share of GDP is about 3 percent. We are sitting here with debt as a percent of GDP of about 40 to 50 percent. That is net debt.

Now, we think you've got a responsibility to move forward and stimulate your economy in a very meaningful way. And would we not be in a better position to go to the Germans and say, look, you know, we are getting our economic house in order here. And how about bringing those rates down more and faster and let's get some economic growth here going worldwide? Wouldn't we be in a better position to say that if we passed this deficit reduction program the President has put before the American people?

Mr. SUMMERS. No question about it. It is integral to any effort to promote international economic cooperation for growth.

Senator SASSER. And if we don't, conversely, are we right back in the same old soup we have been in for years, where we say, you do that, and they say, you do that, and nothing happens?

Mr. SUMMERS. It would make things much more difficult.

Senator SASSER. I would like to get that on the record.

Now, with regard to the Japanese, Mr. Secretary, Dennis Incarnation, a professor at the Harvard Business School has written a new book about the United States-Japanese relationship, entitled *Rivals Beyond Trade,* and I don't know if you are familiar with this book or not. But the thrust of it is this: in the book he argues that a major reason for Japan's persistent trade surplus with our country is related to the gross imbalance in direct investment.

Japan, he argues, follows policies of restricting U.S. investment in their country while their firms expand investment here. As a result, two thirds of all American imports from Japan are shipped as "intracompany exports."

For example, Honda in Japan shipping to Honda in Marysville, OH. And the parts are then assembled into an automobile. Toyota

in Japan ships to Toyota in Kentucky, and they are assembled into a Toyota automobile and sold here.

Now the question I asked, do you think this point that is made by Mr. Incarnation about the relationship of trade and investment has merit?

Mr. SUMMERS. I am not familiar with the details of his book. I am familiar with the argument. If you look at United States foreign direct investment in Japan, it really stands out for being so small. And I think that there is a very strong argument to be made that increased foreign investment in Japan by the United States would be export-creating, not export substituting.

The question you always have to ask about evaluating foreign investment is: Is the foreign investment replacing production that otherwise would have taken place in the United States? Or is the foreign production stimulating sales that will involve a larger content of imports from the United States than otherwise would have taken place?

I am convinced that United States foreign direct investment to Japan would be export-enhancing for the United States and I think it is something that we therefore have to work to achieve.

Senator SASSER. What sort of policy should we adopt to further that goal? Do you have any idea about that at this point?

Mr. SUMMERS. I do not want to get ahead of the framework that is in the process of being developed for the content of the United States economic discussion with Japan over the next several years. But I think that there is a very real chance that foreign investment and policies directed at it will be included in that framework.

Senator SASSER. All right. Thanks.

Senator Sarbanes.

Senator SARBANES. Mr. Secretary, on page 6 of your report, in your table, you show the United States current account deteriorating from $62 billion last year to $101 billion this year and a further deterioration to $131 billion next year. Now, this deteriorating trend is obviously a core cause of real concern. You report earlier on page 4 of the report, "IMF projections for growth this year are zero for France, 0.3 percent for Italy, −1.3 percent for Germany." Essentially, Europe is in deepening recession. And you also note that Japan had the lowest growth in 20 years last year and it is not expected to do better this year.

What actions ought to be taken to sort of alter this—I mean, we are getting a stagnant or indeed recessionary situation worldwide at a time when our own economy has yet to come out of the last recession in any real sense. What ought to be done?

Mr. SUMMERS. I think, as the report suggests, we see domestic demand led growth on a large scale in Japan as an important priority. And we see the need for preconditions to be laid and then for interest rates to fall in Europe so that there can be a revival of growth in Europe. And I think those points—fiscal policy in Japan and interest rates in Europe—are key to global growth.

Senator SARBANES. First of all, the Japanese fiscal stimulus tends to concentrate on infrastructure spending as a rule, which fails to pull in a lot of imports.

Second, even if you have the possibility of increased imports, we run into all of the barriers and friction. And I don't know quite how

you're going to do the fiscal policy in a way to accomplish what you just talked about.

Now, in Europe, the interest rates, that leads me into the fact that the Wall Street Journal yesterday reported that the Federal Reserve officials voted to lean toward higher interest rates at their closed door meetings last week. I want to put this in a sort of calm and reasonable way if I can.

Senator SASSER. I missed something there. Is the Senator referring to the open market committee leaning to higher interest rates last week?

Senator SARBANES. That's right.

As I understand it, two members wanted to take the rates up and cast formal votes in favor of higher rates. And this I am now reading in the Wall Street Journal report:

This suggests that some other Fed officials are sympathetic to the idea.

Now, given the weakness of the world economy, which we have just discussed, and the tentativeness of the United States recovery, do you think it would be wise for there to be a tightening of monetary policy in the United States at this time?

Mr. SUMMERS. I do not want to get into the business of making prescriptions as to what the Federal Reserve system should do. Growth is obviously a critical concern, and I think that, as one looks at growth forecasts in the United States today, there is more room on the down side for disappointment than there is room on the up side for our growth—for too rapid growth to become a problem.

But one can never entirely discount the fear of inflation. And one does have to be concerned by the recent inflation statistics. So I do not want to get in the business——

Senator SARBANES. You are prepared to go to the Europeans and urge them to lower interest rates at the same time you would be prepared to raise interest rates in the United States as part of a global strategy to get the world economy moving again; would that be correct?

Mr. SUMMERS. The Treasury does not, and certainly the Under Secretary for International Affairs, does not, determine interest rates in the United States. I did not make the suggestion about what I was prepared to do with respect to U.S. interest rates. As far as Europe is concerned——

Senator SARBANES. You want the Europeans to lower their rates?

Mr. SUMMERS. As far as Europe is concerned, it would be desirable to see conditions for stable inflationary growth that would make possible reductions in interest rates. The goal is not to try to revive inflation in Europe, but the goal is to see the kinds of moderation and budget deficits, moderation in wage growth, that would make possible monetary stimulus through lower interest rates to contribute to more rapid growth.

Senator SARBANES. Now, Hobart Rowan had a column in the Washington Post only a few days ago in which he said:

Besieged Clinton needs Fed help with economy.

You would not regard raising interest rates as constituting Fed help, would you, with regard to the economy?

Mr. SUMMERS. Clearly, higher interest rates do not contribute to more rapid growth in the short run.

Senator SARBANES. In fact, the Clinton fiscal policy is contractionary, is it not?

Mr. SUMMERS. I think in analyzing the fiscal policy you have to look at what the effects of the fiscal policy are on long-run expectations in the bond market. And I think one recognizes the 75 basis point reduction in long term rates we have seen as a consequence of the program, that it quite clearly will have a net stimulative effect on the economy.

Senator SARBANES. But you are depending on the interest rate side of the economy to provide the stimulus, are you not. The taxing and spending aspects of it are contractionary. It will take demand out of the economy, will it not, in and of themselves? You hope to offset it by an increased demand as a consequence of lower interest rates; is that correct?

Mr. SUMMERS. In a tautological sense, whenever you reduce the budget deficit, you are reducing the net of spending and taxing as a source of demand on the economy, so yes, the Clinton program is one of deficit reduction. But we are convinced that it is one that will be providing stimulus to the economy because of its impact on expectations feeding through long term interest rates.

Senator SARBANES. Suppose the Fed starts moving in the direction of a tighter monetary policy and raising interest rates? Doesn't that directly contradict what you're trying to do?

Mr. SUMMERS. If the Fed raises interest rates, as I said, I think that will reduce growth, that will reduce growth relative to what it otherwise would have been in the short run. My hope is that inflation will not be a problem and that there will be no reason at any point to adjust interest rates. But I think——

Senator SARBANES. Isn't there a danger that if you reduce growth your deficit reduction program will in fact result in an increase in the deficit? Reduced growth will contribute to the deficit problem, will it not?

Mr. SUMMERS. Yes, it will. And growth is a critical priority. Growth is influenced by both fiscal and monetary policies. There is no solution to any of this country's economic problems without more rapid growth. But it is critical that the growth we get not be a 6-month or a 1-year flash, but that the growth be sustainable.

I think the lesson that we have learned is that we have to focus on the sustainability of growth as well, and it is for that reason as well as the traditional boundaries that I am reluctant to make prescriptions as to what the Federal Reserve should do.

Senator SARBANES. How confident are you that there is going to be 2 to 3 percent growth this year?

Mr. SUMMERS. No economic forecaster is ever wise if he is very confident in his forecasting. Two to 3 percent range——

Senator SARBANES. If the Congress carries out this contractionary fiscal policy and if the Fed moves to a contractionary monetary policy, would not that make it less likely that we would achieve a 2 to 3 percent growth rate this year?

Mr. SUMMERS. I don't think that there is any question that, in the short run, short run contractionary policy is indeed contractionary.

Senator SARBANES. Let me just make this point. You just cannot—the problem is that if you get these contractionary policies in the short run, which increase your deficit problem, as they are very likely to do, and also increase your unemployment problem and your growth problem, you are on a line that you simply cannot sustain, because your problems are worsening and not getting better. The trend line is not turning around for you.

And it seems to me that, you know, the administration—if the Fed does not provide a monetary—as Rowan says here, "Besieged Clinton needs Fed help with the economy," in fact he concludes by saying that Greenspan should be urged to nudge money rates down further.

Senator SASSER. This is Hobart Rowan?

Senator SARBANES. Yes. And not have this story here that they are considering raising rates. I mean, we are really going to be in the soup if we have a contractionary fiscal policy and, at the same time, the Fed moves toward a contractionary monetary policy.

And it seems to me—I mean, I think that you have indicated some concern, although I know that you're trying to be careful here. But at some point, it seems to me, that if the Fed is not going to help this expansion, I don't know where the expansion is going to come from. And if we do not get the expansion, we are going to have a problem on the jobs front, on the growth front, and on the deficit front. And I don't see how you can go to the Europeans and ask them to cut their rates and to start to get things moving and at the same time the rates are being raised in the United States.

Mr. SUMMERS. Senator Sarbanes, I would just say that I share your concern about the absolute centrality of growth to everything the administration is trying to achieve. I would note that growth depends upon short term interest rates and on long term interest rates, and that long term interest rates have a great deal to do with inflation expectations and the credibility of the policy that is being pursued. But I don't think there is any question that the top priority for economic policy over the next year has to be accelerating the rate of growth in the American economy.

Senator SARBANES. Thank you, Mr. Chairman.

Senator SASSER. I thank you, Senator Sarbanes.

One final question, Mr. Secretary. I am concerned about the Treasury's new report that shows that Japan's global trade surplus is going to mushroom to $130 billion this year. $50 billion of that will be with the United States.

Now, on April 28, the New York Times, in an article entitled "U.S. Wants Group 7 to Focus on Trade," you Mr. Secretary were portrayed as showing exasperation with Japan's trade surpluses and trade practices. You were quoted as saying:

> Trade imbalances between countries say something important about the openness of markets and the fairness of competition in these markets.

If you are fairly quoted and if you were exasperated, I say bully for you and would urge you on along that line.

Now, what specific steps is this administration planning to take to open up Japan's markets to us? Are macropolicies enough to try to get that done or not?

Mr. SUMMERS. At the meeting that President Clinton had with Prime Minister Miazawa, the absolute importance of the economic

relationship to the broader relationship between the two countries was stressed. And at that time, the President very clearly called for economic discussions to take on new energy.

The framework for those discussions is being developed, and I don't think it would be appropriate for me to go into detail on it here. I would say that framework is premised on the recognition of two important issues with respect to Japan's trade patterns.

One is what one might refer to as the imbalance problem that is heavily macroeconomic in nature, and it refers to the gaps between savings and investment and to the $130 billion global surplus that you referred to.

The other is what one might refer to as the penetration problem, the fact that even when Japan's current account surplus was significantly reduced, as it was at the beginning of this decade, there were still very substantial trade concerns having to do with ability of businesses from other countries to penetrate the Japanese market.

That penetration problem is perhaps manifested by comparisons of quantity of Japanese manufactured imports relative to our goods market, with that in other countries. And that penetration problem is a second problem that has to be addressed, and it has to be addressed through measures that relate to trade policies.

Obviously the two reinforce each other. A more open Japanese market will respond more to stimulus in terms of imports. A growing Japanese economy will be one where there will be more political pressure to liberalize things.

But I am confident that we will be able to pursue actively the question of the economic relationship with Japan addressing both the imbalance problem and the penetration problem with tools that are both macroeconomic and microeconomic. In a sense, they are like blades of a scissors. You cannot make economic progress without using both of them.

Senator SASSER. Do you have any further questions?

Senator SARBANES. I have one, Mr. Chairman.

I want to briefly address the Taiwan situation. And of course, we run with Taiwan our third largest trade imbalance, a very large one, given the size of the respective economies.

Taiwan actually has the world's second largest foreign exchange reserves, not relative to their economy, but in absolute terms. I mean, it is just—any table you look at, that figure sort of leaps out at you.

Now, you say in your report that it is your judgment that they are not at this time manipulating the rate of exchange for purposes of preventing effective balance of payments adjustment or gain in unfair competitive advantage in international trade. You then go on, on page 18, to say that:

> Meetings were held with Taiwan authorities after determining before that it was manipulating its currency. Despite these negotiations, Taiwan has not made any significant changes in the array of controls and practices that provide the authorities with sufficient scope to manipulate or strongly influence the exchange rates.

And then you say, the central bank promised to review them. No significant action has subsequently been taken.

The Taiwan authorities appear to hope that by retaining the capability to manipulate or strongly influence the exchange rates,

they will be able to slow or avoid the gradual internationalization of the NT dollar that should accompany the island's growing economic stature as a global trader and investor.

Now what it appears is that Taiwan has kept in place all of the mechanisms to manipulate its exchange rates while refraining, for the moment, from actually doing so. Now, that is better than actually doing it, but it still means that this whole system is there. The control regime is there.

And what is your reaction to that and how important an objective is it to actually get the dismantling of that control regime? Otherwise, even the presence of it constitutes, I would think, some influence and restraint on normal operations. And, of course, it could be kicked back in at any time.

Mr. SUMMERS. We will certainly continue to work at that and we will be vigilant with respect to the possibility that those mechanisms will be used again for the purpose of manipulation.

But, at this point we felt that enough progress had been made and results in terms of Taiwan's trade patterns had changed enough that it would be inappropriate to label them as a manipulator. But that does not mean that the process of our dialog with them will stop.

Senator SARBANES. I want it understood that we are following this matter very closely. And, as reflected, we were reading your total report on Taiwan and I identified what I thought was the underpinning. There is a difference between the underpinning and what is happening, and it is simply through self-restraint, as it were. And that, I think, ought to remain a matter of concern with respect to this matter. I assume that Taiwan will again be addressed with great care and scrutiny in the report that will be coming to us in the fall.

Mr. SUMMERS. Absolutely.

Senator SARBANES. Thank you very much.

Senator SASSER. Thank you very much, Senator Sarbanes. I will just end the hearing this morning on this note, Mr. Secretary. I want to commend you and the administration for reinvigorating G–7, the G–7 negotiations, and I think that is very, very important and I agree with you that if we continue to have any credibility with the G–7 it is very, very important that we pass the administration's deficit reduction program her in the Congress.

I also would like to say that I think Senator Sarbanes is right on target in his statement that if we are going to pass the Clinton deficit reduction program, which is going to put in place a moderately restrictive fiscal policy at a time when the country is experiencing very slow economic growth, it is imperative that we have cooperation on the monetary side from the Fed.

And I think it is unthinkable that they be contemplating raising rates at this particular time, at a very critical, crucial time, as I think this economy and as the world economies are striving hard to try to reach some level of economic growth and recovery.

The committee is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Prepared statement of witness and additional material for the record follow:]

STATEMENT OF LAWRENCE H. SUMMERS
UNDER SECRETARY OF THE TREASURY

MAY 25, 1992

Mr. Chairman and Members of the Committee: It is a pleasure to be here today to present the Treasury Department's spring 1993 Report on International Economic and Exchange Rate Policy.

The title of the Report is becoming increasingly outmoded. The distinction between domestic and international economic policy no longer exists, if it ever did. Today, for example exports and imports each account for roughly 11 percent of national income. In recent years, over half of U.S. income growth and almost all of our growth in manufacturing jobs have been due to growth in exports.

It used to be said that when the U.S. sneezed, the world caught a cold. The opposite is equally true today. Our prosperity is linked inextricably to the maintenance of a strong world economy, open international trading system, and stable global financial markets.

Global Growth

This reality underlies the Clinton Administration's international economic policy. This policy starts from the critical premise that a strong competitive economy is the most effective international economic policy. We recognize that, while the battle of imports and exports may be fought at the border, domestic policies, in the final analysis, will determine the outcome.

The President has outlined a bold and ambitious program to reduce the budget deficit and revitalize the American economy. The success of this effort will depend importantly on preserving and strengthening an open, growing world economy. It is for this reason that we have placed emphasis on and effort into reinvigorating the G–7 economic policy coordination process.

The President's economic program has brought us new credibility in the international economic arena; it has strengthened our hand in encouraging our major trading partners to take complementary actions to strengthen growth in their own countries. We have also succeeded in changing the atmosphere in the meetings, from confrontation to frank discussion, by avoiding public lecturing and recognizing that each country must decide its policies on the basis of its national interests. But increasingly, where economic growth is concerned, national interests and international imperatives coincide. Finally, we are improving the analytical framework for the surveillance of our economies.

The need for effective cooperation with our G–7 partners has never been clearer than now. We are in the third year of sub-par growth and the prospects for sustained recovery are by no means certain. The United States is experiencing a modest recovery, but with inadequate job creation. Growth in Europe is weak, unemployment high and rising, and recovery still in the distance. Japan is expected to grow only 1.3 percent this year, the lowest rate in nearly 20 years, and its growing external surplus continues to be a drag on the rest of the world.

We have made a beginning and the initial fruits of this effort are being realized. However, we are not out of the woods and more must be done. The prospect of significant U.S. budget deficit reduction and improved saving and investment have been received favorably by the most critical judge, the markets. Long-term interest rates have declined substantially. Some have suggested that the decline reflects a weak economy. However, forecasts for the economy are up, the stock market has increased and credit quality spreads have narrowed. This suggests that the interest rate decline is due to greater confidence in deficit reduction and not a weaker economy. It would be tragic, however, if the nay-sayers succeeded in defeating the President's program, with the result being both higher interest rates and a weaker economy.

Japan's latest stimulus package is a useful first step but needs to be sustained. The economy is operating well below productive capacity, and consumer and investor confidence is weak. As a result, the trade surplus continues to rise, with new forecasts indicating it could reach over 3 percent of GDP next year.

What the world and Japan needs is a multi-year commitment to use fiscal policy to achieve domestic demand-led growth and to promote substantial external adjustment. The authorities are now in the process or formulating the guidelines for spending in the fiscal 1994 budget. We hope these guidelines will send a message that the April 1993 supplemental stimulus package will be reinforced in next year's budget with continued support for domestic demand.

In Europe, interest rates have come down from their peaks. The pace of decline needs to quicken, however. If the current recession is to be brought to an early end.

Moreover, structural reforms, particularly in labor markets, are required urgently to produce greater wage and price flexibility. This would permit economies to adjust more effectively to external developments, without damaging growth, especially given the constraints on exchange rate adjustments.

Negotiations with China, Taiwan, and South Korea

A growing world economy and an open international trade and payments system are like two blades of a scissors. You need both to cut to your objective, increased U.S. exports. It is for this reason that President Clinton is committed to a "prompt and successful completion of the [Uruguay] Round" and to implementation of the NAFTA. It also is the basis for our efforts to confront bilaterally the special problems posed by countries with chronic export surpluses, including those that use their exchange and payments systems to impede imports.

In 1992, U.S. exports to China, Taiwan and Korea totalled $37 billion. Exports to Taiwan grew by 15 percent and to China by 19 percent, far exceeding the 6.2 percent growth in total U.S. exports. However, to reach our full potential in these expanding markets, it is essential that their foreign exchange systems be open so that their importers are able to purchase and pay for foreign goods and services.

China

The Chinese economy has grown enormously in recent years and continues to exhibit tremendous potential. Growth last year exceeded 12 percent and in the first quarter this year reached 14 percent on an annual basis. While the economy is now showing signs of overheating, with inflation accelerating, China probably will continue to sustain high real growth over the coming decade. With China increasingly needing high tech imports, the United States has a good chance of sustaining strong growth in exports to China.

That potential for growth appears to be restrained, however, by the opaque and arbitrary foreign exchange system which simply turns away potential importers. Foreign and American joint ventures in China report that they cannot obtain even the small amount of foreign exchange in the swap centers that they are allocated under government regulations. This shortage of foreign exchange is so severe that Chinese enterprises are beginning to turn once again to the black market. The situation has been exacerbated by companies' hoarding foreign exchange for their own use or for private trading, possibly in offshore financial markets. Hoarding has reduced the supply of foreign exchange to the swap centers and increased pressure for depreciation of the renminbi.

Last year China sustained global trade and current account surpluses, although they declined substantially from 1991 levels. China's bilateral surplus with the United States increased from almost $13 billion in 1991 to over $18 billion in 1992. These outcomes, as well as the pervasive and inflexible restrictions on access to foreign exchange in China, have led Treasury to conclude that China manipulates its foreign exchange system in a manner that prevents effective balance of payments adjustment.

In my recent negotiations with officials from the People's Bank of China, I strongly reiterated the point made by many others in this Administration that China's trade surplus with the United States is a very serious matter that must be addressed by Chinese action now. I stressed that China's foreign exchange controls were acting as trade barriers and were limiting the ability of U.S. firms to export to China. These exchange restrictions will have a bearing on progress made toward China's entry into the GATT.

I also stressed in my talks with Chinese officials that, while China's current account surplus may be on a declining trend in 1992–93, this appeared to be occurring only because China's economy is overheating, with high growth and rising inflation approaching a danger zone. As growth drops to a more sustainable pace, we could expect China's import growth to diminish and the current account to remain in surplus. In that context, a liberalized foreign exchange regime would be necessary to promote the correction of payments imbalances. I also suggested that overall reform of China's foreign exchange system would contribute to a sounder, more evenly paced macroeconomic policy.

These negotiations will continue in the coming months. I believe that the Chinese authorities share our reform goals, although, unfortunately, they will not commit to a specific timetable for implementation of reforms. We will continue to seek action, both in China and other high growth Asian economies, in order to secure access for exports of U.S. goods and services.

Korea and Taiwan

In the past, both Korea and Taiwan were determined to be currency manipulators. While Taiwan was cited as recently as last December, we do not at this time believe that either Korea or Taiwan meets the criteria for that determination.

Korea's global trade and current accounts remain in deficit, albeit substantially reduced from 1991 levels. We have discerned no activity in the foreign exchange market which would signify intervention to influence the exchange rate. However, Korea maintains a system of foreign exchange and capital controls that limit trade and investment flows and thereby dampen the influence of market forces in the foreign exchange market.

In our recent contacts with Korean officials, we have stressed that these controls limit our ability to export to and invest in Korea, and particularly limit the scope of our financial institutions' activities in Korea. We will sustain our efforts to promote market opening.

Taiwan's overall current account remains large but fell significantly from 1991. While the United States remains in bilateral deficit with Taiwan, it does not appear at this time that Taiwan is intervening in the exchange market to limit appreciation of the New Taiwan (NT) dollar. Furthermore, Taiwan's capital controls do not appear to be constraining capital inflows or appreciation of the NT dollar, although the existence of these controls leaves the potential for future interference in exchange rate movements.

Treasury is actively engaged in negotiations with the Taiwan authorities to eliminate the capital controls that can deter potential demand for the NT dollar and to open further its financial services markets to U.S. institutions.

Conclusion

Sound growth in our principal trading partners, coupled with open trade and payments systems, is increasingly essential to the health of the U.S. economy. We have reinvigorated cooperation with other major countries and have begun to see prospects for enhanced growth, but more must be done. U.S. exports to the emerging economic powers of Asia are growing, but not achieving their full potential. At the present time, only China is found to be manipulating its foreign exchange system; however, we remain attentive to the policies of Korea and Taiwan as well.

DEPARTMENT OF THE TREASURY REPORT TO THE CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

MAY 1993

Part I: Summary and Conclusions

This interim report discusses developments in U.S. international economic policy, including exchange rate policy, since the fifth annual report to Congress submitted in December 1992. These reports are required under Section 3005 of the Omnibus Trade and Competitiveness Act of 1988.

While economic recovery is clearly underway in North America, real growth in Japan and Europe is extremely weak. Japan is experiencing its slowest growth in twenty years. Stagnation characterizes most European countries. The United States recovery is itself moderate, with limited creation of new jobs. A burgeoning surplus in Japan's current account is threatening to reverse the considerable progress achieved in reducing the external imbalances of the latter part of the 1980's. A positive development in almost all industrial countries is the further ebbing of inflation.

In the face of these developments, the new Administration has sought to reinvigorate the coordination of economic policy among the major industrial countries to strengthen the world economy. In particular, it has sought to create an environment more conducive to frank and informal discussion; suggested ways to improve the analytical framework for considering key issues; and recognized that coordination must take account of national differences and interests rather than seek a common approach. This effort is already producing results. The Finance Ministers and Central Bank Governors of the seven Summit countries (G–7) have agreed that their national objectives of increased growth converge with their international interests and are seeking to implement cooperative policies that reflect their differing economic conditions:

- for the United States and Canada, improved domestic savings and investment, primarily through substantial reductions in fiscal deficits;
- for Europe, measures to stimulate private demand and combat rising unemployment, particularly through further declines in interest rates as a result of imple-

mentation of medium-term budget consolidation plans and containment of labor costs and inflation pressures; and

- for Japan, substantial stimulus of domestic demand, which will contribute to reduction of its large external surplus.

Implementation of these policies will lay the basis for sustainable economic growth and reduction of unemployment in the G–7 countries and other market economies. Passage of President Clinton's economic program is the essential U.S. contribution to this agreed approach. In addition, the G–7 are agreed that all must undertake a broad range of structural reforms in order to increase their long-term growth potential, and that a further opening of the international trading system is indispensable for maximizing world growth.

Because of the differing economic conditions and prospects among major countries, the U.S. trade and current account deficits widened somewhat in 1992 and are likely to increase further in 1993. Nevertheless, the U.S. competitive position is strong; the current trend of widening external deficits should slow and eventually reverse course, provided that the G–7 growth strategy outlined above is achieved.

The dollar's value has not changed much in recent months on a trade-weighted basis. However, this overall stability largely reflected offsetting moves against different currencies. A moderate appreciation against European currencies was mainly attributable to the differing prospects for interest rates in Europe and the United States. A decline vs. the yen can be seen as a reflection of forces tending to limit and ultimately reverse Japan's widening trade surplus.

The Administration believes that exchange rates should reflect economic fundamentals and that attempts to artificially influence or manipulate exchange rates are inappropriate. At the same time, excessive volatility of exchange rates is counterproductive for growth. Consequently, the United States remains ready to cooperate in exchange markets with its G–7 partners.

Exchange rate policies of emerging trading powers such as China, Korea, and Taiwan continued to receive the close attention of U.S. authorities. These countries have at various times in the past been deemed to be "manipulating" the exchange rate of their currencies vs. the dollar in the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988. The Treasury Department has held a combination of formal and informal talks with the authorities of these countries aimed at encouraging the removal of measures which do or might discourage appreciation of their currencies in response to market forces.

In this report, Treasury has concluded that China manipulates its foreign exchange system. China's global trade and current accounts remained in surplus in 1992, although these surpluses have declined somewhat, and its foreign reserves have increased further. Its bilateral surplus with the United States widened. Despite these factors, China continues to maintain significant limits on foreign exchange activity which impede balance of payments adjustments by restricting imports.

It is Treasury's judgement that Taiwan is no longer manipulating its currency. A significant element in the analysis underlying this conclusion is that Taiwan's global current account and trade surpluses narrowed significantly in 1992, and its bilateral surplus with the United States declined. However, the Department remains seriously concerned that significant restrictions on foreign exchange trading and international capital transactions remain and may be reducing demand for the NT dollar. Although the depreciation of that currency in recent months was not the consequence of official actions that could be deemed a manipulation, Treasury notes that the instruments needed for manipulation are still in place.

As in the December 1992 Report, the Treasury Department does not find that South Korea has been manipulating the exchange rate of the won. South Korea continues to register deficits in its trade and current accounts, although they narrowed sharply in 1992. Korea's bilateral trade balance with the United States registered a surplus and foreign reserves increased to the highest level ever recorded. However, the authorities do not appear to be intervening in the exchange market to prevent an appreciation of the won.

Part II: Global Economic Developments, Impact on U.S. Balance of Payments, and the G–7 Response

A. Economic Situation in the G–7 Countries

Growth

Real GDP growth in the G–7 countries in 1993 now shows a clear distinction between an expanding North America and a Europe and Japan in recession/stagnation. The U.S. recovery appears clearly on track—although growth remains unusu-

ally moderate for a recovery period—while **Canada** also is on an expansionary path. The International Monetary Fund (IMF) now projects (see Table 1 below) U.S. real GDP growth of 3.2 percent on a year-over-year basis for both 1993 and 1994, while Canada is expected to grow at a 3.2 percent rate this year and 4.4 percent in 1994.

Table 1
G-7 Real GDP Growth
(% change y/y)

	1992	1993F	1994F
United States	2.1%	3.2%	3.2%
Japan	1.3	1.3	3.5
Germany*	2.0	-1.3	1.7
France	1.4	0.0	2.3
United Kingdom	-0.6	1.4	3.1
Italy	0.9	0.3	1.9
Canada	0.9	3.2	4.4
Total G-7	1.6	1.9	3.0

* All Germany; comparable figures for GDP growth in western Germany only are 1.5%, -2.0% and 1.2%. F = forecast; source: IMF, World Economic Outlook, April 1993

Growth in **Japan** has decelerated sharply; last year's performance was the lowest in nearly 20 years. Exports were strong, however, as Japan's markets in Asia experienced solid growth and recovery in North America continued. The stock market and land price declines have made both borrowers and lenders more cautious, and the earlier boom in private investment led to a build-up of plant and equipment that may now seem excessive to business decision makers. Thus consumption and private investment spending are likely to remain subdued for some time. The Japanese authorities have announced a substantial fiscal expansion package, to be put into effect this year. While this package is a welcome first step, a sustained effort is needed to put Japan back on its potential growth path and to reduce its large external surpluses. The IMF staff's projection of 1.3 percent real GDP growth for Japan this year *includes* the estimated impact of the fiscal program in the current calendar year. Thus it appears that the fiscal package has served more to prevent a recession or near recession than to guarantee a strong expansion. With this in mind, the Fund's projection that Japanese growth will snap back to 3.5 percent in 1994 without further policy action could be optimistic.

The outlook for **Europe** is very disappointing. Of the four largest countries, only the United Kingdom is expected to show measurable positive growth in 1993, and the low forecast of only 1.4 percent growth for this year follows two recession years. The decline in German interest rates since last summer's peaks is an encouraging sign, but the cautious nature of the Bundesbank's action, together with the normal lags in the impact of monetary policy, will likely mean that recovery in Europe is delayed until 1994. For the EC as a whole, the IMF sees essentially no growth (+0.1 percent) this year and only 2.2 percent for 1994.

Inflation

Inflation has been declining in most G–7 countries, and low inflation for the G–7 as a group is likely to continue. IMF projections for consumer price increases (see Table 2 below) show inflation at the lowest aggregate rates (excepting the 1986–88 period when world petroleum prices fell sharply) since the early 1960's.

Table 2
G-7 Consumer Price Inflation
(% change y/y)

	1992	1993F	1994F
United States	3.0%	3.0%	3.1%
Japan	1.6	1.0	1.5
Germany*	4.5	4.4	2.5
France	2.3	2.0	2.5
United Kingdom	3.8	2.1	4.0
Italy	5.4	5.7	5.2
Canada	1.5	2.3	2.0
Total G-7	3.0	2.8	2.9

* All Germany; comparable figures for western Germany only are 4.0%, 3.8% and 2.1%.
F= forecast; source: IMF, World Economic Outlook, April 1993

While Italy continues to have the highest inflation rate among the G–7 (although the rate is now declining), inflation in Germany has been of major concern, in part because high interest rates in Germany to contain inflation have spread to other European countries and impeded economic recovery. However, Germany's inflation outlook is slowly improving. Consumer price inflation has been raised temporarily by the one percentage point rise in value added tax on January 1, which added about half a point to the year-over-year rate for western Germany (4.2 percent in March 1993). Significantly lower wage settlements this year—in the 3 to 3½ percent range, vs. 5½ to 6 percent last spring—should contribute to a lower inflation picture which should be visible in coming months. Slower monetary growth is also now evident.

External Account Developments

The most important development in the external accounts of the G–7 countries has been **Japan's** record high and rising trade and current account surpluses. IMF projections for the G–7 are shown in Table 3.

Table 3
G-7 Current Account Balances
($ billions (% GDP))

	1992		1993F		1994F	
United States	-$62.4	(-1.0)	-$101	(-1.6)	-$131	(-2.0)
Japan	+117.6	(3.2)	+137	(3.4)	+128	(3.0)
Germany*	-25.9	(-1.3)	-27	(-1.4)	-24	(-1.2)
France	+ 2.5	(0.2)	+2	(0.2)	+3	(0.3)
United Kingdom	-21.1	(-2.0)	-26	(-2.8)	-26	(-2.7)
Italy	-25.2	(-2.1)	-16	(-1.6)	-14	(-1.3)
Canada	-23.6	(-4.2)	-19	(3.3)	-15	(-2.4)
Total G-7	-38.1	(-0.2)	-49	(-0.3)	-79	(-0.5)

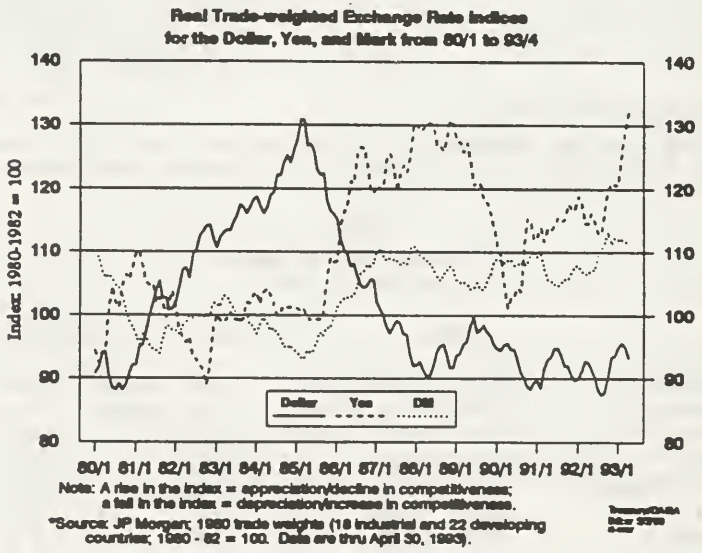
* All Germany
F= forecast; source: IMF, World Economic Outlook, April 1993

The IMF's forecast of a modest decline in the Japanese surplus next year is open to doubt. (In the preceding two years, the Fund tended to underestimate the surplus significantly.) With projected stronger growth in Europe and Canada, and continued solid growth in the United States (3.2 percent) and in Asian developing countries (6½ percent), Japanese exports should continue to grow. (Using Bank of Japan price deflators to derive indices of Japanese export and import volumes indicates that the volume of Japanese exports grew 8.0 percent in 1991 and 5.3 percent in 1992, while the volume of imports grew only 2.6 percent in 1991 and actually fell 1.4 percent in 1992.) Imports are likely to remain weak as the Japanese economy grows below trend performance. The yen's rise earlier this year, if sustained, would eventually provide some counterweight to the forces tending to increase Japan's surpluses. On balance, however, it is still possible that Japan's surpluses could increase rather than decrease next year.

The Fund also may have overestimated U.S. current account deficits for 1993 and 1994. While the U.S. deficit is expected to rise to over $100 billion by 1994 (see the section on the U.S. balance of payments), the moderate nature of the U.S. expansion and the strong competitive position of U.S. exports (of both goods and services) should help restrain the rise in the trade and current account deficits of the United States.

On the latter point, Chart 1 shows the value of the dollar (and yen and DM) in relation to the currencies of a number of major trading partners, adjusted for differences in national inflation rates. These real trade-weighted exchange rates for the three most important world currencies are at least a rough measure of national trade price competitiveness. The chart shows that the dollar has maintained the competitive position it regained by early 1988, with only moderate fluctuations since that time on a real trade-weighted basis. The yen, on the other hand, has risen to levels which are now the highest in the period shown (January 1980–April 1993). The DM has shown less dramatic changes. Exchange rate movements for the period since early October 1992 are described in greater detail below.

Chart 1



B. Developments in Foreign Exchange Markets

Overview

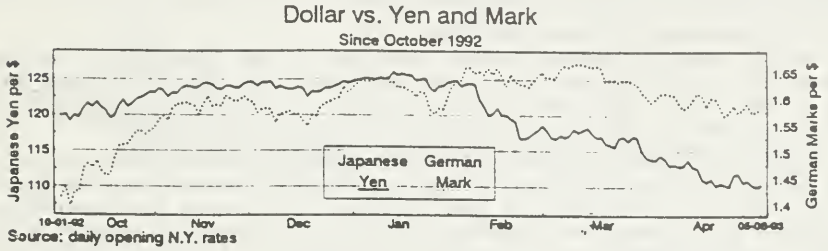
Since early October 1992, the dollar has declined by approximately 8 percent vs. the Japanese yen and has appreciated by approximately 11 percent vs. the German mark. On a trade weighted basis, the dollar rose by 0.1 percent.

The main factor affecting dollar movements against European currencies was the difference in cyclical conditions in the United States and Europe. The dollar firmed

amid a recovery in the U.S. economy and a downturn in Europe, which contributed to expectations in the market that interest rate differentials unfavorable to dollar placements would narrow. Meanwhile, Japan's economic slowdown weighed on the yen, although the effect on the yen/dollar exchange rate was mitigated by uncertainty about the U.S. presidential election and, later, about the policy direction of the new Administration.

Subsequently, cyclical disparities between the United States and Japan were overshadowed by market perceptions that the G–7 countries, and perhaps the United States in particular, would favor appreciation of the yen as a means of addressing Japan's trade surplus. Also, there was a broader concern in the market that the United States might welcome a decline of the dollar against other currencies as well.

Chart 2



Differing Economic Cycles

The pace of the U.S. economy in the fourth quarter of 1992 led market participants to believe that prospects for further monetary easing by the Federal Reserve had all but ended. Expectations of fiscal stimulus measures under the new Administration were also a factor.

Meanwhile, deteriorating economic conditions in Europe encouraged expectations that interest rates there would trend lower. Some European central banks began lowering interest rates in the weeks following the September currency crisis in the European Monetary System. The Bundesbank lowered its official rates in February, but the market remained unconvinced that a monetary easing cycle had definitively begun in Germany. Subsequently, it became apparent that further easing by the Bundesbank would proceed very gradually.

Moreover, the market was disappointed with "soft" U.S. economic growth in the first quarter and early second quarter of 1993. Consequently, there was little incentive to take on long dollar positions, particularly amid only a gradual narrowing of interest rate differentials unfavorable to dollar placements. Declines in German money rates and, in April, a further official interest reduction by the Bundesbank did not materially change this situation.

The market also viewed Japan's economic adjustment, particularly the decline in domestic demand and the involuntary accumulation of inventories, with mounting concern. The political situation in Japan compounded the market's caution toward yen assets. However, the market saw that, relative to Europe, Japan had little scope for further reducing its already low interest rates and better prospects for economic recovery. Although confined to a narrow range against the dollar, the yen appreciated in terms of European currencies.

There were signs in the first quarter of 1993 that the Japanese economy was nearing a cyclical bottom and would soon be poised to begin a recovery. The Bank of Japan's action to lower interest rates in early February was welcomed in the market and contributed to the emergence of more positive market sentiment toward yen assets amid a rebound in the Japanese stock market and expectations of a fiscal stimulus to support economic recovery.

Market Perceptions of Official Policies

Amid signs of slow growth in the United States and a steeper than expected decline in Continental European economics, the yen appreciated to a record level of Y 109.25 in April. A key factor in this appreciation was the belief in the market that the G–7 countries viewed a higher yen as a means of addressing Japan's widening trade surplus.

The yen's appreciation was particularly sharp during February, when many market participants expected the G–7 to make a pronouncement specifically in favor of a higher yen. However, the February G–7 meeting did not result in such a call. Ahead of another G–7 meeting in April, Japanese officials expressed concern about prospects for further yen appreciation, and there were reports of Japanese intervention to curb the yen's rise. The U.S. authorities were also reported to have intervened at one point. The April meeting also produced no specific references to the yen, and exchange rates have remained relatively steady since.

The clarification of U.S. policies on exchange rates was designed to keep the market's focus on the real issues of the economic policies that are needed among G–7 countries to support sustainable, non-inflationary economic growth. As stated in the communique of the April G–7 meeting, a cooperative strategy for non-inflationary growth, based on sound policies, structural reforms, and more open trade, will foster conditions in currency markets that will reflect economic fundamentals. The major challenge that the G–7 faces is to restore growth and to ensure that the composition of growth contributes to the reduction of trade imbalances.

C. U.S. Balance of Payments Situation

The U.S. trade and current account deficits rose in 1992, alter declining for four consecutive years. This reversal was not unexpected, since the U.S. economy was in a recovery mode while major trading partners were heading into recession. Thus, the deterioration in the U.S. external position is *not* seen as symptomatic of a decline in U.S. competitiveness, but rather as the result of cyclical factors.

The *trade deficit* rose to $96 billion in 1992, compared with $73 billion for 1991. Reflecting the cyclical situation, U.S. exports slowed while imports grew over 9 percent after a very slight decline in 1991. U.S. export performance was characterized by a slight fall in exports to Europe and Japan in value terms, but increases to all other major geographic areas. Exports to Latin America, especially Mexico, rose sharply. Overall, export growth was substantially below rates of recent years, when the trade deficit was declining. Imports picked-up from near stagnation in 1991. The pick-up was primarily in finished manufactures, notably capital and consumer goods. Reflecting the impetus from stronger U.S. growth, increases in imports were spread across geographic areas and supplier countries.

On a regional basis, the largest contributors to the total trade balance deterioration of $23 billion were W. Europe (−$12 billion), Japan (−$6 billion), and China (−$5.5 billion).

Table 4
U.S. Trade with Selected Areas: 1991&92
($ billion; data from Survey of Current Business)

Country or Region	Exports to 1991	Exports to 1992	Imports from 1991	Imports from 1992	Balance 1991	Balance 1992
W. Europe	116.8	114.4	101.9	111.4	+14.9	+3.0
Japan	47.2	46.9	91.5	96.9	-44.3	-50.0
China	6.3	7.5	19.0	25.7	-12.7	-18.2
Asian NIEs	44.4	46.9	59.2	62.4	-14.8	-15.5
L. America	63.2	75.3	63.0	69.2	0.3	+6.2
R. O. W.	138.1	148.3	154.8	169.9	-16.8	-21.8
TOTAL	416.0	439.3	489.4	535.5	-73.4	-96.3

By contrast with the merchandise trade balance, the balance on trade in services recorded a substantial surplus ($55 billion) in 1992, $10 billion higher than the 1991 surplus. Trade in a wide range of services had emerged as a major area of U.S. competitive advantage, recording steadily rising surpluses in recent years.

Net investment income also reflected the relative cyclical position. Receipts on U.S. direct investments abroad, weakened by the recession in Europe, fell while the reviving U.S. economy produced a shift from losses to modest gains on foreign direct investments in this country. The overall surplus on net investment income fell to $10 billion, a $6 billion decline which partially offset the gain on services transactions.

Given the relatively modest size of balances in other categories of transactions, the current account balance has tended to move with the trade balance over time. For 1992, the current account deficit rose—after adjustment to remove the one-time influence of foreign transfers in support of Desert Storm—by $16 billion, compared with $23 billion for the trade deficit.

Table 5
U.S. Trade and Current Account: 1987; 1991-2
($ billion: data from Survey of Current Business)

Balance	1987	1991	1992
Trade	-160	-73	-96
Services	8	45	55
Investment Income	11	16	10
Transfers	-23	-34*	-31
Current Account	-163	-46*	-62

*Adjusted to exclude $42 billion in transfers from allies in support of Desert Storm.

Recorded net capital inflows totalled $75.6 billion, of which $24.3 billion was accounted for by private flows while the remainder reflected official transactions. (The difference between the current account deficit and the recorded capital flow is categorized as the "statistical discrepancy".) By contrast with the large inflows of recent years, there was a small *outflow* from the United States by foreign direct investors in 1992, which combined with continued investment activity abroad by U.S. direct investors to generate a net direct investment outflow of $39 billion. Foreign purchases of U.S. securities rose by $14 billion, while there was a substantial net inflow ($47 billion) through banking channels.

Prospects for 1993 and 1994

The relative growth performance of the United States and major trading partners is expected to dominate the trade and current account outlook for 1993 and into 1994.

- Based on present prospects for U.S. and foreign growth, it seems likely that the U.S. trade and current account deficits will increase this year and next, with an expanding trade deficit overwhelming a further increase in the net surplus on trade in services.
- The trade deficit probably will rise to well over $100 billion this year, and the current account deficit may well reach or exceed $100 billion in 1994.

A sustained upward trend in the deficits could be of particular concern if the gap became so large that very rapid export growth was required just to keep the gap from widening further. (For example, when the trade deficit was at its peak in 1987, exports were only about 60 percent as large as imports. This meant that exports had to grow nearly 1½ times as fast as imports *just to avoid further increases in the deficit.* At present, exports total over 80 percent of imports.)

There are important differences between the present situation and the episode of rising deficits during the mid-1980's, however.

- The U.S. competitive position is strong in merchandise trade as well as the growing services industries. Exports are sluggish because some overseas markets are not growing.
- U.S. national saving should increase, rather than deteriorate as was the case during the 1980's, particularly with adoption of the President's economic program.
- Important sources of surging imports during the first half of the 1980's are no longer present.
  - —An increasing share of U.S. sales by Japanese auto firms is now sourced in the United States. Thus, imports of Japanese autos have declined as a percent of Japanese market share. Moreover, total Japanese market share has declined, reflecting the more competitive position of U.S. auto makers.
  - —Exchange rate changes have reduced the strong competitive advantage previously enjoyed by the Asian NIE's.

D. New G–7 Cooperative Approach to Growth

Two major, interrelated international economic challenges presented themselves to the new Administration upon taking office: (1) reinvigorating the G–7 process in order to (2) help strengthen the global economic recovery. The need for concerted G–7 action was made clear by the moderate nature of the U.S. recovery, continued sub-par prospects in the other major countries, and growing external imbalances. At the same time, there were concerns over the G–7's inability in recent years to agree to a common approach to promoting growth due to cyclical divergences in performance among countries and differences in economic priorities.

Revitalizing the G–7 is a high priority of the Administration because of the increasingly significant impact of global trade and capital flows on U.S. economic prospects. Rising net exports of goods and services accounted for 40 percent of U.S. growth between 1987 and 1991 and contributed importantly to new, comparatively high-paying jobs. Thus, the slowdown in overseas markets in 1992 and continued weak prospects in 1993 are of particular concern. In addition, the recent Group of Ten (G–10) study on International Capital Movements and Foreign Exchange Markets underscores the importance of efforts by the major industrial countries to implement compatible policies in order to ensure efficient and stable financial markets.

Against the backdrop of continued economic uncertainty, the United States took the lead beginning earlier this year in coordinating a new cooperative G–7 approach which would (1) ensure a strong recovery that created jobs and (2) establish the basis for sustainable growth over the medium term. Rapid and tangible progress has been made over the past few months.

At an informal G–7 Ministerial meeting in London on February 27, Secretary Bentsen presented the President's economic program to his G–7 colleagues. The new program was well-received as both a serious contribution to world growth and a tangible reflection of the U.S. commitment to enhanced G–7 coordination. By making politically difficult choices on a comprehensive deficit reduction plan—something our allies have recommended for some time now—the United States gained valuable credibility which enhanced the possibility of eliciting complementary policy actions by others, particularly Japan and Germany.

The new U.S. approach reflects changes in tone as well as substance in fostering a new cooperative G–7 approach to growth. As noted earlier, the U.S. has sought to foster a more results-oriented process that encourages more frank and informal discussions. To enhance the quality of G–7 surveillance over economic developments, a common analytical framework is being developed to improve the comparability of economic data across countries. To facilitate actions toward mutually desired goals, this new approach recognizes the need to take into account national differences and interests, rather than seeking a common approach, which too often proves elusive and which may not be appropriate given the unique circumstances in each country.

Recent actions by the United States, Germany, and Japan reflect the convergence of national objectives and international interests:

(1) The President's economic program offers a blueprint for sustainable growth this year and into the future. The new package's inclusion of substantial deficit reduction measures totaling $500 billion over five years and measures to increase public and private investment are critical to improving U.S. competitiveness and growth prospects.

(2) The 13 trillion yen ($119 billion) Japanese fiscal stimulus package represents a positive step toward boosting domestic demand and reducing the growing trade surplus. Further actions may be warranted, however. Most analysts estimate that only about half of this package clearly represents a direct addition to domestic demand. As noted earlier, the IMF forecasts only 1.3 percent Japanese growth this year *after* accounting for the stimulus package. The Japanese economy is operating below its potential, and a sustained fiscal stimulus is the most effective means for increasing growth in a timely fashion. Japan's strong fiscal and net public debt positions provide ample room for further action in this regard.

(3) The pace of reductions in German interest rates may be quickening. Just prior to the recent G–7 Ministerial, monetary authorities cut the Lombard rate by ½ a percentage point to 8.5 percent (reducing short-term interest rates to levels some 220 basis points below September 1992 rates). Recent Bundesbank actions and comments appear to reflect the view that the balance of risks in the German economy have swung from inflation to stagnation. Accelerated action to reduce interest rates appears warranted. The Solidarity Pact among German labor, business, and federal and state governments should help contain wage increases and reduce government borrowing over the medium-term, enhancing the scope for a further easing of interest rates.

Recent Japanese and German measures to increase growth represent significant complements to the President's economic program that should result over time in increased U.S. exports and jobs as economic growth picks up in Europe and Japan. At the same time, the United States has made clear that more actions may be warranted to ensure a strong recovery. For its part, the United States must implement the President's program in order to maintain the momentum of current policy directions, including further complementary policy measures in Japan and Germany. G–7 countries will continue to monitor the impact of these actions and have reaffirmed their continued commitment to close cooperation in exchange markets.

Part III: Newly Industrialized Asian Economies and China

Under Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, the Secretary is required, on an annual basis, to "consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations . . . on an expedited basis . . . for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate unfair advantage."

In the first report (fall 1988), Treasury determined that Taiwan and Korea manipulated their currencies within the meaning of the legislation. Following bilateral negotiations, Treasury concluded that, while significant problems remained, Taiwan (as of the fall 1989 report) and Korea (as of the spring 1990 report) were no longer manipulating their currencies. These findings were reaffirmed in fall 1990, spring 1991, and fall 1991. The applicability of Section 3004 to China was first considered in fall of 1990; in that report and in the spring and fall 1991 reports, Treasury noted that China's exchange rate controls were of serious concern but did not find that currency manipulation was occurring.

In the spring and fall 1992 reports, Treasury reaffirmed its determination that Korea was not manipulating its currency. However, with regard to Taiwan, Treasury determined that Taiwan was once again manipulating its currency, as it was using central bank intervention and restrictions on foreign exchange transactions and capital flows to constrain demand for the NT dollar, even though its external surpluses were increasing.

With respect to China, Treasury found that China was also manipulating its currency. The basis for the changed judgement was the continued devaluation of the administered exchange rate, despite growing external surpluses, and the significant control exercised by the authorities over foreign exchange swap center rates which had also depreciated since the emergence of the large surpluses.

As a result of these manipulation findings, Treasury initiated negotiations with China and Taiwan during 1992. The remainder of this chapter describes the results of those negotiations, as well as recent balance of payments and exchange rate developments, and assesses the foreign exchange systems of China, Taiwan, and Korea.

Taiwan

Taiwan continues to have a material global current account surplus and a significant bilateral trade surplus with the United States: However, it is the judgement of the Treasury Department that Taiwan is not at this time manipulating the rate of exchange between the New Taiwan (NT) dollar and the U.S. dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade.

Notwithstanding this determination, and particularly in view of the fact that Taiwan continues to have large external imbalances (including a $9.4 billion trade surplus with the United States in 1992), the Treasury Department remains seriously concerned that restrictions maintained by Taiwan on foreign exchange transactions and capital flows continue to reduce market demand for the NT dollar and thereby amount, in effect, to indirect manipulation of the exchange rate.

Despite several rounds of negotiations during 1992, Taiwan appears unwilling to remove the restrictions that can constrain demand for the NT dollar and unwilling to guarantee that it will not again engage in practices that constitute direct manipulation of the exchange rate. Permitting the full range of market forces to determine

the level of demand for the NT dollar would likely contribute to further adjustment of the existing bilateral trade imbalance.

Trade and Economic Developments

Significant adjustment seems to be taking place in Taiwan's overall external imbalances. The current account surplus fell 34 percent to $7.9 billion in 1992 (3.8 percent of GDP) from $12.0 billion in 1991 (6.8 percent of GDP). This decline was attributable both to a smaller overall merchandise trade surplus, which fell to $9.5 billion from $13.3 billion in 1991 (a decline of 29 percent) and to a larger deficit in services and income, which rose to $4.7 billion in 1992 compared to $3.5 billion in 1991.

However, recent adjustment in Taiwan's bilateral trade surplus with the United States has been rather modest. The 1992 surplus of $9.4 billion represents only a slight decline from $9.8 billion in 1991, less than half the adjustment that occurred in 1991. Data for the first three months of 1993 show a continued decline in the imbalance. U.S. exports to Taiwan grew 15.3 percent in 1992 compared to 1991, substantially faster than the 6.3 percent growth in overall U.S. exports.

Taiwan ended 1992 with $87.3 billion in foreign exchange reserves, equal to roughly 14 months of imports, and, after Germany, had the world's second largest holdings. By comparison, the industrial countries, on average, hold non-gold reserves equivalent to 2–3 months of import cover.

Exchange Rate Developments

Market pressures have resulted in a depreciation of the NT dollar since the December 1992 report, which is likely to impede further reduction of the bilateral imbalance. The exchange rate stood at NT$ 25.96 per U.S. dollar on May 19. The NT dollar has depreciated 2.2 percent since end-1992, and 5.7 percent since it reached a record high in July 1992. The NT$ appreciated a scant 1.3 percent during 1992. The recent decline of the NT dollar and consequent increase in Taiwan's global competitiveness would have been even greater if exchange rate changes against non-dollar currencies and inflation differentials are taken into account.

The NT dollar has declined even more markedly against the Japanese yen—13 percent since end-1992 alone. As Taiwan purchases most of its imports from Japan (30 percent in 1992) and the United States (21 percent in 1992); a depreciation of this magnitude will raise import prices and increase inflationary pressures in Taiwan's domestic economy.

Exchange Rate System

Taiwan retains a variety of controls and restrictions that provide scope for currency manipulation. Collectively, these controls help to limit the volume of trading in Taiwan's foreign exchange market, which remains small and thin. As a consequence, the central bank can still exert strong influence in the foreign exchange market. The key controls described below were covered more fully in the fall 1992 report; no significant changes have occurred since that report.

The lack of transparency in activities of the central bank means that it continues to retains the ability to intervene directly in the exchange market, use proxies to intervene indirectly, or manage purchases by state-owned corporations.

Ceilings on foreign exchange liabilities, which vary from bank to bank, still affect forward trading in the NT dollar. The ceilings also constrain the ability of foreign bank branches, including branches of U.S. banks, to offer foreign currency loans in Taiwan and to use swap funding for local currency lending. In place of the quantitative limits imposed by these ceilings, prudential concerns in this area could be addressed through other means, such as through risk-based capital requirements that apply to the financial institution as a whole.

The scope of the forward foreign exchange market is restricted by a number of rules that prohibit transactions for non-trade-related purposes, limit trading to authorized banks, impose a sizable deposit guarantee, and limit the maximum forward period to one year. These restrictions also prevent foreign banks and securities firms both in and outside of Taiwan from hedging capital in Taiwan's onshore market.

Non-trade-related capital inflows and outflows are limited to $5 million per firm or individual (capital flows for trade purposes are unlimited). The amount of cash an individual may carry in and out of Taiwan is limited to NT$40,000 (about $1,500).

The ability of foreign institutional investors to invest in Taiwan (i.e., in NT dollar-denominated financial instruments) is constrained by government regulation, in part due to fears that such investment will increase the demand for NT dollars. Restrictions include a cap on the aggregate amount of foreign investment in the stock market, limits on the amount of capital that can be brought in by any one investor, and a minimum time that must elapse before capital and earnings can be repatri-

ated. Investment by foreign individuals is prohibited altogether. Efforts by Taiwan to improve the attractiveness of its financial markets could increase foreign interest and promote capital inflows that could lead to increased demand for the NT dollar.

Exchange Rate Negotiations

After determining that Taiwan was manipulating its currency under Section 3004, Treasury held four meetings with the Taiwan authorities during the course of 1992. Despite these negotiations, Taiwan has not made any significant changes in the array of controls and practices that provide the authorities with sufficient scope to manipulate or strongly influence the exchange rate. During the last round of negotiations, the central bank promised publicly to review its controls with the intention of removing those that are unnecessary, a commitment that it has not fulfilled. No significant action has subsequently been taken, though Taiwan has taken several very modest steps to remove impediments to appreciation of the NT dollar.[1] The Taiwan authorities appear to hope that, by retaining a capability to manipulate or strongly influence the exchange rate, they will be able to slow or avoid the gradual internationalization of the NT dollar that should accompany the island's growing economic stature as a global trader and investor.

Assessment

The present determination represents a change from Treasury's assessments of May and December 1992 that, in the context of Taiwan's large and increasing external imbalances, the system of exchange and capital controls maintained by the central bank, as well as its direct and indirect involvement in the exchange market, constituted manipulation of the currency.

Three developments described above have led to our changed determination. First, the array of controls on capital inflows and exchange transactions maintained by the central bank do not appear at this time to be *directly* constraining appreciation of the NT dollar. Second, it does not appear that the central bank has been intervening in the exchange market to dampen pressures for appreciation. Instead, on a number of occasions during the past several months it appears to have intervened in the market to support the NT dollar. Finally, significant adjustment seems to be taking place in Taiwan's overall current account surplus.

With regard to the outlook for further reduction in Taiwan's trade imbalance with the United States, the imbalance may grow without NT dollar appreciation in the months ahead. In view of the lack of appreciation in the NT dollar during 1992, Taiwan's exporters may become even more competitive in world markets, particularly in the U.S. market as our own economy grows more rapidly than Taiwan's other export markets.

Consequently, Treasury remains concerned that, if strong market pressures for NT dollar appreciation recur in the period ahead, Taiwan might again resort to currency manipulation, using instruments at its disposal, in order to limit the rise of the NT dollar. Taiwan expects that its economy will continue to grow strongly. Taiwan has targeted GNP growth of 7 percent in 1993, up from 6.1 percent in 1992. Interest-rate differentials between NT dollar- and U.S. dollar-denominated assets appear to be increasing as monetary policy tightens in response to re-emerging inflationary pressures. Confidence in Taiwan's stock market seems to be growing, which has fueled foreign interest and spurred capital inflows from foreign institutional investors. Political uncertainty has diminished with the election of a new Legislative Yuan in December 1992 and the appointment of a new premier and cabinet in February 1993.

Because of the serious nature of these concerns, Treasury will continue to monitor Taiwan's exchange rate policies closely in the period leading up to the next report to Congress to determine whether the authorities are again manipulating the exchange rate of Taiwan's currency and to ensure that the exchange rate is playing an appropriate role in adjustment of Taiwan's external imbalances, including its bilateral trade surplus with the United States.

In this regard, Treasury would view official actions or practices that interfere with the role of market forces in exchange rate determination—such as intervention in the foreign exchange market to dampen pressures for appreciation or maintenance of restrictions on foreign exchange transactions or capital inflows that appear to constrain NT dollar appreciation—as an effort by the authorities to manipulate the

[1]The foreign exchange liabilities ceiling for all commercial banks was raised in two stages from $19.2 billion to $20.6 billion. Also, the ceiling on investment by a foreign institutional investor was effectively raised from $50 million to $100 million (after the first $50 million is brought in, an institutional investor can apply to bring in another $50 million).

exchange rate to inhibit effective balance of payments adjustment and gain unfair competitive advantage in international trade.

Furthermore, Treasury will use further discussions to seek changes in Taiwan's exchange rate policies and restrictions on capital movements with respect to both their impact on external adjustment, and their harmful effect on U.S. financial firms in Taiwan. Finally, with regard to Taiwan's accession to the GATT and the economic and political benefits GATT membership will bring, the United States has noted that, under the GATT Articles, Taiwan must negotiate a special exchange arrangement with GATT members to ensure that Taiwan cannot use exchange rate policies to frustrate the intent of GATT trade provisions.

South Korea

The Treasury Department does not find the Korean authorities to be manipulating the exchange rate directly to gain unfair competitive advantage in international trade or to prevent effective balance of payments adjustments. Korea's external deficits were reduced significantly in 1992 as economic growth slowed following the implementation of stabilization policies in late 1991 and throughout 1992. There continues to be little evidence that the Korean central bank is intervening in the exchange market, and the level of activity of other government-owned foreign exchange banks in the market has been minimal since the fall 1992 report. Treasury remains concerned, however, about the continued prevalence of stringent foreign exchange and capital controls that thwart the influence of market forces in the determination of Korea's exchange rate and trade and investment flows. Such controls frustrate the emergence of a truly market-determined exchange rate.

Recent Developments

The Korean economy in 1992 experienced the consolidation of a process of adjustment after the 1990–91 period of overheated growth. Real GNP growth slowed to 4.7 percent, compared to 8.4 percent in 1991 and 9.4 percent in 1990. At the same time, substantial progress was made in addressing the effects of two years of excessive domestic demand caused in part by expansive financial policies initiated in 1989. Consumer price inflation in 1992, at 4.5 percent (down from 9.3 percent in 1991), was the lowest in six years.

In 1992, the current account deficit was cut nearly in half to $4.6 billion (1.6 percent of GNP) from $8.7 billion in 1991 (3.1 percent of GNP). Stabilization policies to cool domestic demand and the overheated construction sector resulted in import growth of just under 1 percent, compared to 17.7 percent a year earlier. Although export growth declined from 10.3 percent in 1991 to 7.9 percent in 1992, exports grew faster than imports for the first time since 1988. The overall trade deficit fell in 1992 to $2.2 billion from $7 billion in 1991.

According to the U.S. Department of Commerce, the United States recorded a bilateral trade deficit with Korea of $2.1 billion in 1992, compared to $1.5 billion in 1991. Korean data show a slight surplus for the United States in 1992, and indicate that Korea also had deficits with Japan, the EC, and China, but surpluses with countries in Southeast Asia and Latin America.

In the capital account, overall net capital inflows totalled $7.8 billion in 1992, up from $4.2 billion a year earlier. The increase is largely the result of a rise in long-term capital inflows following the limited opening of the Korean stock market to foreign investment in January 1992. The level of Korea's net foreign debt declined by 8.2 percent from $11.9 billion in 1991 to $11 billion in 1992 (3.7 percent of GNP). Korea's debt service ratio is estimated to have remained stable in 1992 at 6 percent.

Korea's foreign exchange reserves maintained an upward trend in 1992 in conjunction with the continued improvement in the external accounts, rising $3.4 billion to $17.1 billion (2.7 months of import coverage), the highest level ever recorded.

As of May 19, 1993, the exchange rate stood at 801.1 won per dollar, representing a nominal depreciation of 1.2 percent since the end of 1992. Since the inception of the market average rate (MAR) system on March 2, 1990 (see fall 1992 report for description of this system), the won has depreciated against the dollar by 15 percent, due largely to higher inflation in Korea and the emergence of trade and current account deficits in 1990.

Foreign Exchange and Capital Controls

A broad array of controls on foreign exchange and capital account transactions in Korea continues to prevent market forces from playing a fully effective role in exchange rate determination, distorts trade and investment flows, and constitutes a potential channel for Korean monetary authorities to influence the exchange rate.

The so-called "real demand rule," which requires foreign exchange banks to obtain and review documentation of an underlying commercial transaction for most foreign

exchange transactions, continues to impede the development of the Korean foreign exchange market and financial sector as a whole. Korea's restrictive terms for deferred import payment, especially regulations that limit payback periods to only a fraction of international norms, continue to be of key concern, as are tight restrictions on off-shore financing alternatives. While there have been a few limited steps since the fall 1992 report to ease controls in some of these areas, much remains to be done to enhance the role of market forces in the determination of the exchange rate and trade and investment flows. Reaching the Korea's stated goal of integrating the Korean financial sector into global capital markets will require the Korean authorities to take bolder steps toward shortening significantly the list of prohibited foreign exchange and capital transactions and to move forward with broad-based reform of the financial sector.

Status of Financial Policy Talks

Although no formal Financial Policy Talks (FPT) have been held between Treasury and Ministry of Finance officials since the last report, informal dialogue has continued as Korea moves toward completion of the Financial Sector Liberalization Blueprint (FSLB) announced in the March 1992 FPT (see fall 1992 report for further discussion). A parallel package of reform measures to deregulate the domestic financial industry is under formulation as well. While the two plans overlap in a number of key areas, the FSLB addresses to a greater extent issues relating to increased market access and other aspects of the internationalization of Korea's financial sector. The final measures of both plans will be incorporated into Korea's "Five Year New Economy Plan," slated for completion in June 1993.

Treasury's assessment of Korea's reform efforts will focus on both the substance and timing of the implementation of policies which target the lifting of foreign exchange and capital controls; liberalization of interest rates; elimination of directed credit schemes; adoption of indirect means of monetary control; further opening of the stock market to foreign investment; and enhancement of local currency funding sources for U.S. and other foreign financial institutions operating in Korea.

China

As China maintains significant restrictions on all aspects of foreign exchange activity in China, it is Treasury's judgement that China manipulates its foreign exchange system by restricting imports and that this action impedes effective balance of payments adjustment. Of particular concern are China's priority list of permissible imports and restrictions on access to foreign exchange. Moreover, China maintained a global current account surplus in 1992 and a large bilateral trade surplus with the United States. There have been no significant changes in China's foreign exchange system since the December 1992 Exchange Rate Report to Congress.

Trade and Economic Developments

China's global trade and current account surpluses remain substantial although they continued to fall in 1992. China reported that merchandise imports rose 26 percent in 1992 to $80.6 billion while merchandise exports rose 18 percent to $85 billion. As a result, according to Chinese figures, China's merchandise trade surplus dropped from $8.2 billion in 1991 to about $4.4 billion in 1992. Rapid import growth was fueled by strong domestic demand and rapid growth of GDP. China's smaller trade surplus contributed to a decline in China's current account surplus from $13.3 billion in 1991 to a reported $6.4 billion in 1992. Reserves increased by $2.6 billion to reach $46.9 billion in September 1992, about 7 months of import cover.[2] China's current account surpluses have allowed China to meet its debt service obligations with ease. While China's total external debt increased from $60.6 billion in 1991 to $69.3 billion in 1992, its debt service ratio has remained at about 11 percent.

China's bilateral trade surplus with the United States continued to grow rapidly in 1992. According to U.S. data, Chinese exports to the United States increased 37 percent to reach $25.7 billion. Toys, sporting goods, clothing, and footwear continue to be the largest categories of Chinese exports. Chinese imports from the United States rose 19 percent to reach $7.5 billion. Aircraft, fertilizers, measuring equip-

[2] In December 1992, Chinese authorities announced they would change the method used to calculate China's official reserves. Henceforth, foreign exchange held by the Bank of China will not be included in official reserves since it represents the deposits of state enterprises in the Bank of China (a bank controlled by the central government which specializes in foreign exchange transactions). According to the new calculations, China's official reserves for September 1992 would fall from $46.9 billion to $25.0 billion. With the central authorities maintaining a high degree of control over the use of funds held by enterprises in the Bank of China, the higher figure would be more appropriate.

ment, and wheat were the largest categories of imports from the United States in 1992. China's trade surplus with the United States rose from $12.7 billion in 1991 to $18.3 billion, an increase of 44 percent. In 1992, China had the second largest trade surplus with the United States after Japan. U.S. Commerce Department information for January-March 1993 indicates that China's trade surplus with the United States increased $0.8 billion over January-March 1992.

In other economic developments, China's economy grew at an estimated annual rate of 12.8 percent in 1992. Chinese economic growth was spurred by a reform drive early in 1992 and by rapid increases in investment and the money supply. Investment in fixed assets jumped 38 percent over a year earlier while M2 increased 31 percent. In addition, China's domestic saving and investment rates remain high. In 1992, gross national savings stood at 36 percent of GNP while gross domestic investment stood at 34 percent. China's high level of national savings has allowed the country to maintain modest current account surpluses while investing a large portion of GNP. Chinese inflation remained a reported 5.4 percent in 1992, although it appears to be accelerating. The end of period inflation rate was over 7 percent while urban inflation reached 12 percent in 1992.

In the future, the Chinese economy faces a real threat of economic overheating unless the authorities take steps to prevent excessive growth of the money supply and investment. So far the Chinese authorities have not taken such steps. High economic growth continues to affect China's external sector, with preliminary indications that rapid growth in imports may substantially diminish China's trade and overall current account surpluses in 1993. According to Chinese trade figures for January-March 1993, China's imports rose 25 percent over the same period a year earlier while China's exports rose only 7 percent, leaving a global trade deficit of $1.2 billion.[3] But this cyclical development does not provide the promise of correction of the underlying structural imbalances sustained, in part, by distorted exchange markets.

China's Foreign Exchange System

China operates a dual exchange rate system. The official exchange rate is set daily and generally applies to priority imports for state enterprises under the State Plan. China's second exchange rate, the "swap" rate, is determined in foreign exchange adjustment centers. Joint ventures, foreign invested enterprises, and domestic trading firms with access to foreign exchange may buy and sell foreign exchange and foreign exchange quotas at the swap centers. Swap center rates are established through an open bidding system (15 centers) or as the State Administration of Exchange Control matches applications for foreign exchange (approximately 85 centers).

China continues to maintain extensive restrictions on access to foreign exchange. For goods on the restricted list, an enterprise must receive a license from the Ministry of Foreign Trade and Economic Cooperation (MOFTEC)[4] before it may buy foreign exchange in the swap centers. For those goods that do not require MOFTFC approval, access is based on a priority list of uses of foreign exchange drawn up in conformity with state industrial policy. The authorities generally discourage purchased of foreign exchange to finance imports of goods not formally approved by the government. In April 1992 the authorities issued new guidelines outlining priorities for access to foreign exchange in the swap centers. Preferred access was given to those purchasing foreign exchange for agricultural inputs and products, interest payments and remittances, technology imports, and inputs to key construction projects. Access to swap centers was also granted for purchases of foreign exchange for industrial inputs, educational materials, and some spare parts. Purchases of foreign exchange for a wide range of consumer and luxury goods (cigarettes, wine, clothing, household appliances, and film) are prohibited. These limits on access to the swap centers act as barriers to trade since importers cannot purchase foreign exchange to import a wide range of goods.

Treasury's November 1991, May 1992, and December 1992 Reports to Congress contain additional detail on China's foreign exchange system.

Exchange Rate Developments

Since 1980, the Chinese currency has experienced substantial depreciations against major currencies. From 1980 to 1992, the renminbi (as measured at the offi-

[3] Chinese trade figures appear to be undergoing revision. The same trade report indicated a 32 percent drop in exports to Hong Kong and a 97 percent increase in exports to the United States. Changes in Chinese rules of origin and statistical methods may account for part of the change in trade figures.

[4] Formerly the Ministry of Foreign Economic Relations and Trade (MOFERT).

cial exchange rate) depreciated 73 percent versus the U.S. dollar, 85 percent versus the yen, and 71 percent versus the ECU. The depreciation of China's exchange rate has improved China's trade and China's current account positions. In particular, the devaluations of 21 percent in 1989 and 10 percent in 1990 helped China move from a current account deficit of $4.3 billion in 1989 to a current account surplus of $13.8 billion in 1991.

Administered Rate: On May 14, 1993, the official rate of the renminbi stood at 5.74 yuan/dollar. This represents a nominal depreciation of 7.8 percent since the adoption of the "managed float" system in April 1991. In 1992, authorities held the official rate relatively constant from January through August, but allowed the rate to depreciate toward the end of the year. By December 31, 1992, the official exchange rate had depreciated 5.5 percent over a year earlier. For the first three months of 1993, the official exchange rate has remained relatively constant at approximately 5.75 yuan/dollar.

Swap Rate: For the week ending May 14, 1993, the average swap center rate stood at 8.04 yuan/dollar. The swap rate depreciated 23.5 percent in 1992 due largely to increased demand for imports, rapid monetary growth, fears of renewed inflation, and speculation that the Chinese authorities would devalue in preparation for entry into GATT. In 1993, the renminbi reached a low of 8.41 yuan/dollar in February and has since appreciated slightly to 8.04 yuan/dollar. This represents a depreciation of 10 percent since year-end 1992. It appears the Chinese government has intervened in the swap centers to prevent further depreciation of the currency.

The gap between the official and swap center exchange rates has continued to widen, from 10 percent in January 1992 to 40 percent on May 14, 1993.

Exchange Rate Negotiations

Treasury held negotiations with the People's Bank of China in April 1993. In these negotiations, Treasury urged the Chinese to improve access to foreign exchange. In particular, Treasury urged Chinese officials to lengthen the list of imports for which foreign exchange is available and to commit to a timetable for reform. Treasury also urged Chinese officials to move quickly to full current account convertibility, on the ground that such action would eliminate the need for the highly regulated foreign exchange allocation system now in place, which was driving foreign exchange trading to the informal market. These reforms would benefit the Chinese economy more broadly by improving economic efficiency, while addressing many of the U.S. concerns. Once such reforms were undertaken, market forces would then play a greater role in determining the exchange rate response to developments in the external payments position.

Treasury believes that foreign exchange restrictions form an integral part of China's overall trade regime. As such, these restrictions cannot be separated from larger trade questions affecting U.S.-China economic relations. Easing restrictions on access to foreign exchange would represent a step toward liberalizing China's trade regime, reducing the bilateral trade imbalance, and improving economic relations between China and the United States.

In 1992, China began more serious preparations for entry into the GATT. Treasury believes that China's accession to the GATT would be a positive step toward integrating China into the international economic community and beneficial for both China and the United States. Treasury notes that GATT Article XV contains two obligations with respect to exchange restrictions: (1) that GATT members shall not, by exchange action, frustrate the intent of the GATT trade provisions; and (2) that members may apply exchange restrictions only in accordance with the Fund Articles. As it accedes to the GATT, China must bring its exchange system into conformity with GATT Article XV and the IMF Articles of Agreement.

Assessment

While China has committed itself to reform of its trade regime in the context of the market access Memorandum of Understanding (MOU) and GATT, similar commitments have not been made with respect to its foreign exchange system. Chinese officials have expressed general support for reform of the system, including: eliminating the requirement for surrender of foreign exchange, liberalizing access to the swap centers, and making the system more transparent. Chinese authorities have also set forth the long-term objectives of unifying the dual exchange rates and making the currency convertible. However, they have not indicated the specific nature of the steps they plan to take, and have not committed to specific measures or the timing of reform.

While China's current account surplus may diminish in 1993, its foreign exchange restrictions continue to impede balance of payments adjustment and contribute to large bilateral trade surpluses. In 1992 and early 1993, no significant changes were

made in China's foreign exchange regime, and the authorities continue to maintain limits on access to foreign exchange. Therefore, it is Treasury's judgement that China is manipulating its foreign exchange system in a manner that prevents effective balance of payments adjustment within the meaning of Section 3004. We urge the Chinese authorities to take steps to liberalize access to foreign exchange by eliminating the pervasive foreign exchange restrictions that impede the external payments adjustment process.

ASIAN NIES AND CHINA: TRADE AND CURRENCY CHANGES

Cumulative Change against US$ as of May 19, 1993 [1]

Since:	(Plaza) 9/20/85	end–86	end–87	(Initial Report) 10/14/88	end–89	end–90	end–91	end–92	Rate on 5/19/93	
HK$	1.1%	0.8%	0.4%	1.1%	1.0%	0.9%	0.7%	0.2%	HK$	7.73
Won	11.7%	7.5%	−1.1%	−11.3%	−15.3%	−10.6%	−4.5%	−1.2%	W	801.10
Singapore$	36.4%	34.4%	23.5%	25.2%	17.7%	7.7%	0.4%	1.9%	S$	1.61
NT$	56.1%	36.8%	10.0%	11.3%	0.8%	4.4%	−0.8%	−2.1%	NT$	25.96
Yen	118.4%	44.0%	11.5%	14.0%	29.6%	22.4%	12.7%	12.6%	Y	110.85
DM	78.0%	19.6%	−1.5%	11.3%	4.3%	−7.7%	−6.2%	−0.1%	DM	1.62
Yuan	−48.1%	−35.0%	−35.0%	−35.0%	−17.3%	−8.8%	−4.8%	0.8%	Yuan *	5.72

1. [−] signifies depreciation against the U.S. dollar.

** rate on 5/4/93*

U.S. Trade Balance with Asian NIEs and China [2]

(U.S. $ billions)

	1985	1986	1987	1988	1989	1990	1991	1992	1992 Jan–Mar	1993 Jan–Mar
Hong Kong	−5.6	−5.9	−5.9	−4.6	−3.4	−2.8	−1.1	−0.7	−0.1	0.3
Korea	−4.1	−6.4	−8.9	−8.9	−6.3	−4.1	−1.5	−2.1	0.2	−0.5
Singapore	−0.8	−1.3	−2.1	−2.2	−1.6	−1.8	−1.2	−1.7	−0.4	−0.1
Taiwan	−11.7	−14.3	−17.2	−12.6	−13.0	−11.2	−9.8	−9.4	−2.3	−2.0
Total NIEs	−22.1	−27.8	−34.1	−28.2	−24.3	−19.8	−13.7	−13.9	−2.7	−2.2
China	0.0	−1.7	−2.8	−3.5	−6.2	−10.4	−12.7	−18.3	−3.4	−4.2
NIEs + China	−22.1	−29.5	−36.9	−31.7	−30.5	−30.3	−26.4	−32.1	−6.1	−6.4
Total U.S. Trade Bal.	−132.1	−152.7	−152.1	−118.5	−108.6	−101.7	−66.2	−84.3	−11.2	−20.6

2. U.S. customs value data, not seasonally adjusted.
Totals may not equal sum of components due to rounding.

RESPONSE TO QUESTIONS FROM SENATOR RIEGLE BY SECRETARY LAWRENCE H. SUMMERS

Q.1. Mr. Taggart Murphy, a noted expert on Japan's financial markets, wrote an op-ed piece entitled "Stronger Yen, Weaker U.S." that appeared in the May 1, 1993 edition of the *New York Times.* He claims that continuing a policy of weakening the dollar to cure our trade deficit with Japan, begun in the Nixon Administration twenty years ago, will not work. He claimed that:

"Japanese bureaucratic skill at blocking meaningful foreign participation in its economy is the real cause of the trade and investment balances."

Do you think that Mr. Murphy makes a valid point?

A.1. Mr. Murphy's point—that the relative paucity of "meaningful foreign participation" in the Japanese economy is a central factor in Japan's trade and investment surpluses—is well taken. However, it is not the whole story. Japan presents two problems for the rest of the world: an import and investment penetration problem to which the above citation refers, and an overall external imbalance problem.

The unusually low levels of imports of foreign goods and services and inward foreign direct investment relative to the size of Japan's economy compared to that of other major countries illustrates the penetration problem. This anomaly cannot be explained away by the natural qualities of the Japanese economy, e.g., its distance from markets. A number of factors including the complex distribution system and the relatively high price of land contribute to these low penetration levels, but the system of Japanese government regulation and administrative guidance also plays a role. Accordingly, we have identified this problem as an area of concern in our discussions with the Japanese on the new U.S.-Japan economic framework.

However, the overall external imbalance is also a real problem. This is mainly the result of, and is responsive to, macroeconomic factors. For example, between 1987 and 1991, after a substantial adjustment in exchange rates and a sustained period of rapid economic growth, Japan's current account surplus dropped from 3.6 percent of GNP to just 1.2 percent of GNP. Even if we were able to completely eliminate the penetration problems posed by Japan's system of regulation and administrative guidance, Japan's overall current account surpluses would not be sufficiently reduced unless the underlying imbalances in Japan's savings and investment patterns were reduced.

Q.2. Last week in a speech you made to the Japan Society in New York, you stated it would be a Treasury priority to open foreign financial markets and described how Japan, among other things, prevents American investment advisory firms from competing to manage the bulk of Japan's one trillion dollar pension fund business.

We have been negotiating intensively with Japan for over 10 years to open its financial markets to U.S. firms without great success. In that period Japanese financial firms have expanded rapidly in our markets.

Do you think we need to strengthen our bargaining hand by passing legislation such as Fair Trade in Financial Services Act which has passed the Senate several times?

A.2. As Secretary Bentsen stated at his confirmation hearings, Treasury is extremely concerned that certain foreign countries take advantage of our open financial markets yet do not provide U.S. financial firms with a fair opportunity to compete. He noted that Treasury will be pleased to take a close look at the Fair Trade legislation and work with its supporters on an appropriate policy.

I reiterated this view in my own confirmation hearings before your Committee and intend to work toward our objective of assuring that our firms are able to compete fairly in foreign financial markets.

Q.3. Mr. Masaru Hayami, the Chairman of the Japan Association of Corporate Executives, recently wrote an article entitled "Stronger Yen Will Benefit Japan in the Long Run" that appeared in the *Nikkei Weekly*. In the article Mr. Hayami notes that the appreciation of the yen over the years has helped Japanese industry because "it results in lower prices for imported materials including fuel."

Do you agree with that point or do you think dollar depreciation will help our trade balance with Japan?

A.3. I would prefer not to comment on the impact on bilateral trade balances of a given exchange rate since such a discussion is subject to considerable uncertainty and vulnerable to misinterpretation. Speaking more broadly, I would reiterate the Administration's view that exchange rates are determined largely by economic fundamentals. They can be expected to respond to actual or anticipated changes in those fundamentals and in policies designed to affect them. Experience-shows that efforts to artificially influence or manipulate exchange rates are frequently misplaced and inappropriate. At the same time, excessive volatility of exchange rates can be counterproductive and adversely affect growth. Thus, we continue to cooperate closely with our G–7 partners on exchange rates.

Q.4. In the May 21 edition of the Japanese Times, Mr. Hanawa, the Vice President of the Nissan Motor Co., said that his company would lose $50 million yen in revenue if the dollar falls further.

Will this cause Nissan to lose market share here, or will they just shift production to lower cost Asian countries to maintain market share here?

A.4. Obviously, I am not in a position to predict how Nissan might respond to the conditions you described. Were the company to confront a decline in market share, it could presumably take steps to control costs in order to limit such a loss. I would imagine this might include resorting to greater global outsourcing, shifting assembly operations to low-wage locations, or increasing its transplant capacity in the United States. A variety of other factors and possible actions would undoubtedly be considered as well. In this regard, the question is best answered by the man whose comments inspired it: Mr. Hanawa.

Q.3. On page 6 of your report, you show a forecast for the U.S. current account deficit in 1994 of $131 billion. That would be our third

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worst current account deficit ever and more than double last year's deficit. It seems to me that we are not solving this problem. Blaming it all on cyclical differences between our economy and other economies looks to me to be wishful thinking. Your table on the previous page forecasts our economic growth in 1994 at just about the average for the G–7 countries. I think we need some serious action here. How do you propose to deal with this enormous deficit?

A.3. To illustrate the importance of cyclical factors, it is important to understand that exports to Japan and Europe equal nearly 40 percent of total U.S. exports. Exports to these two markets *fell* between 1991 and 1992, after very rapid growth during the 1987–91 period of declining external deficits. Had exports to these markets grown as fast as all other exports, the U.S. trade deficit would have risen by only $3 billion; the current account (excluding effects of Desert Storm) would have *declined* by several billion dollars because we have a large and growing surplus on services transactions.

The weakness of U.S. export markets in Europe and Japan reflects an extended period of sluggish and, in some cases, negative growth, from a level of demand already well below potential. Restoration of growth and a return to full capacity in these major U.S. export markets, as we are working to achieve in G–7, OECD and other fora, would make a major contribution to resumption of a downward trend in the U.S. external deficit.

However, you are correct in noting that removal of cyclical factors still leaves a large external deficit. This remaining deficit reflects in large measure a level of savings in the United States which is inadequate to finance needed levels of investment. If we are to reduce this structural component of the external deficit, we must raise national savings. The Clinton program to reduce the budget deficit by $500 billion over several years is essential if we are to raise the insufficient level of national savings. At the same time, the Administration will continue to pursue a policy of "export activism" to remove barriers and open markets to U.S. exports. Taken as a whole, the success of these efforts could have an important and favorable impact on reducing U.S. external imbalances.

RESPONSE TO QUESTIONS FROM SENATOR SASSER BY SECRETARY LAWRENCE H. SUMMERS

Q.1. ". . . Now, following up on that question, many of our exporters complain about the predatory trading practices of the Europeans and the Japanese. And clearly, currency manipulation by the Chinese would fall within this category as well.

Now, some year ago, we created a so-called War Chest within the Export-Import Bank in order to give the executive branch some flexibility in responding to the predatory practices of so many other countries. Now the question is, could Exim's War Chest or some other program provide an effective response to the kinds of currency manipulation now being undertaken by the Chinese?"

A.1. We understand that the legislative mandate for use of Exim's tied aid credit fund (the "War Chest") precludes its being used to counter currency manipulation. The War Chest was originally enacted to augment U.S. leverage in OECD negotiations to increase disciplines over others' use of trade distorting tied aid credits.

Exim's new charter broadens this mandate somewhat to permit use of the War Chest:

"To supplement the financing of a U.S. export when there is a reasonable expectation that predatory financing will be provided by another country for a sale by a competitor of the U.S. exporter with respect to such export and with special attention to matching tied aid and partially untied aid credits by other governments—(i) in violation of the OECD Arrangement on Guidelines for Officially Supported Export Credits; (ii) in cases in which the Bank determines that U.S. trade or economic interests justify the matching of tied aid credits extended in compliance with the Arrangement, including grandfathered cases."

This language clearly envisages War Chest use to counter predatory financing rather than currency manipulation.

The Administration has indicated that, with agreement on new tied aid rules in the OECD, it would use the War Chest selectively and focus on monitoring and enforcing the new agreement. It is important that the War Chest remain available to enforce the new agreement, which is aimed at disciplining the trade distorting tied aid practices of the principal competitors of U.S. exporters.

If not needed, War Chest resources are available to finance the budget subsidy requirements of Exim's normal lending program, which provides substantially greater financing leverage to promote U.S. exports than does War Chest use.

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